The Canadian Chartered Accountant

OFFICIAL ORGAN OF

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

Published monthly; subscription $3.00 per annum in advance; single copies thirty-five cents. Advertising rates sent on request.

The Editorial Committee will be pleased to receive contributions on subjects of interest. Papers which may not be deemed suitable will be returned, if desired.

Publication Office,
10 Adelaide Street East, Toronto
W. A. McKAGUE, Editor.

VOLUME XLII | APRIL 1943 | ISSUE No. 237

(The opinions expressed in articles in The Canadian Chartered Accountant are the opinions of the writers of the articles and are not necessarily endorsed by the Association.)

Editorial Comment

Federal Affairs

Parliamentary discussion has tended to become more weighty, as the 1943 session has progressed, but up to the time this is written there has been a lack of outstanding material. The main causes of the eclipse of parliamentary influence at the present juncture are, first the considerations of secrecy which becloud allied policy in this critical stage of the war, and second the expansion of our Canadian war production and finance to a scale that does not readily lend itself to parliamentary control. The Dominion budget, which attempts to depict this war effort in figures, is a vast structure which the member of parliament, like the citizen, can only survey with awe. The 1943 edition was so void of either new principle or change in rates that it did not inspire parliamentary debate. In fact when one reviews the infinitesimal changes in the tariff and in the prescribed income tax rates, he is inclined to the conclusion that if it were not for the Ruml idea there would hardly have been anything worth calling a budgetary amendment. However, some commentators and critics have claimed that what the government adopted was not the Ruml plan, but a Canadian scheme including a part of the same fundamental idea.

The very immensity of the figures therefore is the main

feature of the 1943 budget. The government plans to spend the sum of $5,500 millions during the 1943-44 fiscal period. This is eleven times the normal or pre-war rate of federal spending and, since the civil outlay has not materially changed, it means that we are putting up about five billion a year for war purposes, out of a total national income computed at about eight and a half billions. The really serious problem is, how can this very large proportion, of 60 per cent of the income, be extracted from the people. The estimates contemplate that just half the total of $5,500 millions will come from taxes—the rest will have to be borrowed. The Finance Minister said: "The only way to accomplish this financial and economic programme is through increased personal savings, spending less and lending more. Some of the people's savings are mobilized and lent to the government through the insurance companies and other financial institutions. Businesses can contribute savings out of retained profits, unexpended depreciation and maintenance funds and unnecessary working capital. Large subscriptions to loans representing but a temporary shifting of assets will not do what must be done." Now that revenues are fairly stabilized on a wartime scale, the borrowing of the balance, along with the attendant task of economic control, is likely to be the critical domestic problem arising out of the war.

The T. 2 Questionnaire

The Income Tax Division of the Department of National Revenue has during the past few weeks distributed to its branches a "T. 2 Questionnaire" calling upon the corporation taxpayer for a great deal of information as to the way in which its profits, as reported on the present T. 2 tax form, are computed, and which in turn must be accompanied by a report from the corporation's auditors. This is a new departure in tax assessment, and it imposes new problems and responsibilities upon auditors. The feelings of auditors regarding it are mixed, to say the least. There is a sense of new responsibility, but also a measure of apprehension concerning its outcome. The fact remains that the obligation is mandatory, on the taxpaying corporation and through it on the auditor.

Incidental to this step, however, there are a few points which should be clarified. In the first place it is the

government, and certainly not the professsional accountants, that sponsors the questionnaire. The leading organizations, including The Dominion Association of Chartered Accountants, were apprised of it, and were given the opportunity of making suggestions while the form was being planned, and the representatives of the chartered accountants at least believe that their efforts in this regard had the effect of minimizing the difficulties of both the taxpayer and the auditor. At the very start of the discussions, it appeared that the one and only alternative, to the use of such a questionnaire and auditor's report, would be the drafting of more than one hundred additional chartered accountants by the department, to go into the taxpayers' offices for the purpose of obtaining such information—a procedure which would have caused the taxpayer more trouble and which would have further depleted the staffs of accountants in public practice. Again, though the problem of additional auditor's fees and disbursements may not be readily solved all at once, it should be borne in mind that the duty of filling in the questionnaire and securing the necessary auditor's report falls indubitably upon the taxpayer. And finally, next year may see the questionnaire included in the T. 2 form itself. As to the broader implications to the profession, it is worth while to remember that the medical men, who constitute what is probably the most rigidly professional class in the world today, are, whether they like it or not, constantly called upon to make physical examinations and to provide certificates for draft boards, for workers' camps and for numerous other public and semi-public services.

The Institute of Chartered Accountants of Ontario, as soon as it learned of the issue of the questionnaire, arranged for a meeting of its members. The verbatim report of this meeting, published in this issue, should be of special interest at the present time.

Wealth and Risk in Inventories

Under the title of "Our Critical Wealth in Inventories," by Roy A. Foulke, Dun & Bradstreet, Inc., have published a booklet which deals with one of the most absorbing problems of wartime business. No doubt any interested person can secure one of these booklets

from the nearest office of the firm. Mr. Foulke is manager of its specialized report department.

Inventories have been called the graveyard of American business because they have so frequently been the prime cause of business failure. Those who recall or who have studied the few years after the last war will appreciate the truth of this remark. In the present war, price regulations aim to forestall the wide advances which made possible the sharp declines which occurred then, while other economic controls, which are also part and parcel of the price system, aspire to a fair distribution of goods in relation to the war effort and also to the public needs. Nevertheless we can not say as yet how effective these plans may be, nor how stocks of war and peace merchandise may be affected by the impact of peace. The tax barriers against development of a cash position commensurate with the inventory risk is a serious problem today. In this connection the booklet says:

"During the past two years business men have become more inventory conscious than ever before in the history of American industry and commerce. There has been developing a technique of inventory control similar to the technique which has long existed in accounts receivable control. The objective of inventory control is to keep the inventory in a definite relationship with net sales and with net working capital, the conversion of inventory into cash in the shortest possible time, the minimizing of losses through obsolescence, depreciation, and expenses resulting from excessive inventory, and the developing of records to give a constant aging of inventory similar to an aging of receivables."

The booklet discusses various interpretations of cost and market valuations. It includes lengthy tables of ratios for many lines of business.

MEETING ON T.2 QUESTIONNAIRE

The T.2 Questionnaire (on income and excess profits, for use by corporations) was the subject of a meeting of the Institute of Chartered Accountants of Ontario on the evening of 22nd February 1943. The chairman was Mr. Fred C. Hurst, F.C.A., president of the Institute, who explained that the meeting had been arranged because of the immediate importance of this questionnaire to the profession. A number of copies of the questionnaire had been obtained and distributed to the members. Mr. Hurst stated that the Institute had arranged with Mr. Kris A. Mapp, F.C.A., president of the Dominion Association, Mr. James F. Gibson, F.C.A., past president of the Institute and chief corporation auditor of the Income Tax Division of the Department of National Revenue, and Mr. J. G. Glassco, C.A., chairman of the Taxation Committee of the Ontario Institute, to deal with the subject.

Mr. Mapp explained the circumstances leading up to the issue of the questionnaire. Mr. Gibson went over it in detail and commented on the various items. Mr. Glassco dealt particularly with the "instructions to the auditor" and submitted a suggestion in regard to the form and content of the report of the auditor as required by the questionnaire.

In the following verbatim report of the meeting it has been considered unnecessary to reprint the various sections of the questionnaire itself as these are all numbered and as copies of the questionnaire are now available from the offices of the Income Tax Division. Accordingly this report, and particularly the remarks of Mr. Gibson, should be read in conjunction with a copy of the questionnaire.

President's Address

Mr. Mapp: Last September, when it became apparent that new regulations were being promulgated in the office of the Director of National Selective Service, we addressed a communication to the director, asking him that chartered accountants be classified as an "essential" occupation, as they had previously been under the administration of the Department of National War Services. This letter contained particulars as to the numbers of our members who are serving with the armed forces, those in the civil service, those in industry and those who are still in public

practice. We also indicated to the director the numbers of our students—a great many of them, God bless them —who are also serving in the armed services, and told him of some of the things we are required to do in the conduct of our public practices, and asked him for an interview at his convenience, at which time we hoped to be able to discuss in greater detail the matters discussed in the letter.

As you are all aware, at that time, or shortly after that time, there developed a certain amount of turmoil, shall I call it, in the office of the director of National Selective Service, and the fact of the matter is the interview we sought was never arranged. However, immediately, Mr. MacNamara, associate deputy minister of Labour, was appointed the new director of National Selective Service; we asked him for an interview, which he readily granted us. Present at the meeting were K. W. Dalglish, chairman, War Purposes Committee, The Dominion Association of Chartered Accountants, C. F. Elderkin, chairman, Legislation Committee, The Dominion Association of Chartered Accountants, and myself.

Probably I can best convey to you what transpired at that meeting by reading to you a letter which I addressed to the presidents of our provincial institutes shortly after the meeting was held. I think the letter is of sufficient importance to convey its detail to you. (The speaker read the letter above referred to.)

During the course of the negotiations to which I have referred, we learned that the commissioner of income tax, Mr. Fraser Elliott, had placed a requisition on the desk of the director of National Selective Service for a substantial number of accountants to be used in the Income Tax Division of the Department of National Revenue. When I say we learned this, I do not wish to convey any impression of secrecy, because the commissioner had spoken to us about it on more than one occasion. Indeed there was nothing else he could do under the circumstances and no other course he could pursue. Charged as the commissioner is with the duty of collecting, and collecting promptly, taxes in an amount unprecedented in the history of this country —faced, shall I say, with ever-changing conditions in the basis of taxation, and hampered by insufficient staff,— little wonder then that the commissioner should look for

assistance from those who understand his problems and from those who would best serve his requirements. However, be that as it may, we were very much concerned, all of us, for obvious reasons with which we are all familiar, as to where these men could be obtained. So we had a conference with the commissioner at which time we discussed the matter quite frankly and fully. There were several suggestions advanced as to how the problem could be solved, but one suggestion in particular seemed to have a great deal of merit, and gain in favor. It was considered at this meeting of vital importance, indeed of paramount importance, that in the interests of both the crown and the taxpayers, assessments should be kept as closely up to date as humanly possible, and that the work of the department should not be hampered or impeded in any way by lack of co-operation, either on the part of the taxpayer or of his auditor; and with these thoughts in mind and this object in view the suggestion was carefully considered and gradually developed, until you have it before you tonight in the form of the T.2 Questionnaire.

The preparation of this questionnaire was not simple; and I would like to take this opportunity of congratulating the officials of the department on their efficient treatment of an exceedingly difficult subject.

At a conference held in Ottawa, which was ably presided over by Mr. Bullock, the chief assessor of the department, there were present several senior officials of the department, including Mr. Gibson, and, also by invitation, representatives of our Association, and the C.P.A.'s and the C.G.A.'s; and for two days—the first day until well after midnight—we struggled with the questionnaire. We considered it carefully, question by question, and the instructions to the auditor; and I want to assure you, gentlemen, in all these negotiations and discussions there was an earnest endeavour, a keen desire to see to it that there was retained a proper balance as between the crown and the taxpayer, as between the crown and the professional accountant, and as between the professional accountant and his client; and I can only hope we have succeeded in this regard.

Now, I have been asked several times and in several places, "What of the future?" and what effect will this

questionnaire have in our relationships with our clients. It is a perfectly logical question and I can truthfully and honestly say, gentlemen—and this after consulting with many of my fellow members—that I do not believe those relationships will be disturbed in any way. Indeed, I think as the questionnaire is appreciated and its object understood, that those relationships will tend to improve.

The form is prescribed and authorized by the Minister of National Revenue. I take it that that means something, does it not? The taxpayer must answer the question; and our contribution is to be made mandatory, by Order in Council or otherwise.

In the final analysis, gentlemen, I believe that the questionnaire will prove both helpful and beneficial to both the taxpayer and to the auditor; and while today undoubtedly its introduction is an emergency measure, yet I incline to the view that its continuance is assured provided both taxpayer and auditor discharge their obligations in a proper manner.

I feel, gentlemen, that this measure of confidence thus placed in our profession is something that is exceedingly gratifying. We have been charged with a great responsibility; we have been entrusted with an important trust; and I am satisfied, yes, more than satisfied, we will prove worthy of it. Above all, satisfied I am that, as a professional body, we will continue to dedicate our very best efforts to the successful prosecution and termination of the deadly struggle in which we are all engaged; and that also, as a professional body, we will place our services at the disposal of the government, to be used in a manner that will best serve the interests of our country, our worthy allies and our empire. (Applause)

Chairman: I am now going to call on Mr. James Gibson, the immediate past-president of the Ontario Institute, and one of our most popular members, to defend the Dominion government in connection with this questionnaire! (Laughter)

Mr. Gibson's Comments

Mr. Gibson: Mr. president and gentlemen, Mr. Hurst has said I was going to tell you what the department expected the auditor to say in reply to this questionnaire. As a matter of fact the questionnaire is to be answered by the

taxpayer. It may be that some of you will find yourselves preparing the answers to the questionnaire, but that, after all, is a matter of arrangement between yourselves and the client. (Laughter)

One other thing, before I continue, this is the first time I have ever spoken to this Institute in my capacity as a government official. I have been in the job for 15 years, and my staff and I have always tried to build up a spirit of co-operation and friendliness between ourselves and the practising chartered accountants, because most of us, after all, are chartered accountants. I think, substantially, we have managed to do that. (Applause) I take this opportunity of saying that I hope that feeling will continue to prevail in the future.

(Proceeding to discuss the T.2 Questionnaire, Mr. Gibson read each numbered item, and made comments following the items numbered below.)

Nos. 1, 2, 3.—The first items, naturally, call for no comment.

No. 4. (a)—The earliest period for which this form is expected to be filed is the calendar year 1942, and it naturally applies to any period after that as well, and it is to be filed within six months, which gives you an extra two months after the filing date.

No. 4. (b)—I do not think that calls for any comment. Items 6 and 17 are the items calling for specific information.

No. 4. (c)—I believe Mr. Glassco will discuss item 19.

No. 4. (d)—As item 4 (d) says, the object is that the auditor will be required to report on the T.2-Questionnaire, but not on the T.2.

No. 4. (e)—That, of course, is self-explanatory.

No. 5.—I do not think it is necessary to read those items. I may assure you that they are going to be imposed.

No. 6. (a) (Investments)—That, at first, may seem a foolish question, but it is not, as a matter of fact, because dividends received by Canadian companies are not all Canadian dividends by any means, which other dividends are subject to tax. We want to know whether or not the practice is consistent. Are they accruing dividends in one period and not in another?

No. 6. (c)—The same thing applies to this question. We are not particularly interested, providing the taxpayers

follow a common practice, whether they follow the accrued or cash basis, provided it is consistent; but we want to know whether it is consistent.

No. 6. (e)—The answer is Yes or No. Obviously there are various classes of corporations whom we do tax on profits on sales and securities, and to whom we do allow losses incurred, and we want to know what has been done with them.

No. 6. (f)—Either one or the other. As a matter of practice we recognize the amortization of premiums and discounts only in trust companies and finance concerns of that nature. Industrial and commercial concerns we do not tax and we do not allow amortization.

No. 6. (g)—If you have received any distributions on any account in respect of investments, that you have not included in taxable income, tell us what they are. Perhaps they are taxable, perhaps they are not. You may possibly get distribution on stock held in United States concerns. We just want the details, that is all.

No. 7. (a) (Accounts and Bills Receivable)—In other words, did you take a flat percentage of your open book debts? How did you arrive at your amount of bad debts?

No. 7. (b)—Subject to the fact that at the end we ask you to exclude amounts owing by the Dominion government, because we do not feel it is necessary to have any reserve. (Laughter) And we ask you to indicate the percentage of the reserve to the outstandings.

No. 7. (d)—In other words, are you providing for anything that is not a potential loss on accounts receivable? Are you providing for loss on advances made to customers, or loans to subsidiaries? Because we do not recognize those as bad debt losses. To make doubly sure, we ask in (e) (reads item 'e').

No. 8 (Deferred Charges) (a)—Well, I have to scratch my head to remember why that clause is in there. Mr. Mapp has refreshed my memory. He tells me it is, once again, a question of consistency. In other words, are you following the practice of deferring items some years and not others; and (b) follows with the same idea.

No. 9. (Inventories) (a)—Those words in brackets are simply an indication of the type of answer we want. In

other words, how are the quantities arrived at—by test, estimate or actual count, in respect of first, raw materials; second, goods in process; finished products; supplies; other inventories.

No. 9. (b)—That does not mean that if you have goods on hand that are obsolete or unsalable you are obliged to put them in your inventory at any value, but why did you not take them in?

No. 9. (c)—Cost or market. In other words, just what do you mean by cost; what do you mean by market; what do you mean by cost or market? I recall one case where a corporation manufactured various grades of the same thing. Their interpretation of cost was the lowest of the cost of the various grades. They had furnished their auditors with a certificate that their inventory was taken at cost or market. Obviously, it was not at cost on a proper interpretation. So we simply say to you, what do you mean by cost—what is your interpretation of that term; and we ask that of various classifications of inventory.

No. 9. (d)—Are you being consistent in your method of valuing inventories; if in 1941 you included in your inventory valuation of goods in process something for overhead charges, did you, likewise, include a similar calculation in 1942, or did you leave it out? Are you being consistent? As a matter of fact, we do not particularly care whether you do include overhead or not so long as you consistently follow the practice each year.

No. 9. (f)—That is simply a bald question. Have you got an inventory reserve? If so, give us the figures.

No. 10. (Fixed Assets) (a)—I think most of you are, or should be, familiar with the type of depreciation schedule we keep in the department; judging by the number of copies of schedules I send out in my mail every day, I think you must be all familiar with them.

No. 10. (b)—We want to know what the accounting treatment is of what we call profits or losses.

No. 10 (c)—That is simply a question, if the corporation has assets in respect of which we make depletion allowance, of giving particulars each year of what amount is the basis of the claim and also the continuity of the accumulated depletion in respect of the assets.

No. 11. (Current Liabilities) (a)—The object of that question is to find whether or not (and it is not an entirely unusual practice) there has been deferred from a loss period to a profitable period some charge which should have been written off in the loss period.

No. 11. (b)—That is simply a question of fact. Are you carrying forward accrued charges from some previous period?

No. 11. (c)—I think those questions are all self-explanatory—the answer is Yes or No.

No. 12. (Bonds, Funded Debt or Debentures) (a)—We are interested for various reasons—whether new bonds have been issued.

No. 12. (b)—In other words, the consideration received for bonds or debentures is not always cash or real property. I have seen cases where it has been goodwill; and where debentures are issued in consideration of goodwill, we obviously are not going to allow the interest charges on those debentures, unless you can establish the goodwill is worth that amount of money, and that is going to be a pretty tough job.

No. 12. (c)—That is merely an information item.

No. 12. (d)—If you are losing money are you failing to accrue the interest and intending to charge it all in the first period in which you make a lot of money.

No. 12. (e)—That question, of course, is there because there is a provision in the Act that we do not allow any charge in respect of an income bond.

No. 13. (Foreign Exchange) (a)—Naturally, foreign exchange will have considerable effect one way or the other on foreign income, depending on how it is treated. We simply want the facts.

No. 13. (b)—Are you being consistent?

No. 14. (Surplus)—I take it that you gentlemen always clearly reconcile your surplus accounts, but unfortunately some accountants do not, and if we find there is a discrepancy in the surplus account, we have to send a man out, or else telephone.

No. 15. (Capital Stock) (a)—We are naturally interested in capital stock for various reasons. The question is whether there has been any redemption which gives rise to liability under Section 16; and there is also the question as to what the consideration was for new issues.

No. 15. (b)—When you buy depreciable assets, for instance, if you pay cash there is no question about there being an asset.

No. 15. (c)—We simply want to know how much it was.

No. 16. (Profit and Loss for Fiscal Period) (a)—To refresh your memory, I may say that items Nos. 33 to 43 on Form T.2 call for the addition to taxable income of income and excess profits tax, and so forth. In other words have you added back all the items called for in T.2?

No. 16. (b)1 and (b)2—In dealing with the question of repairs, we obviously make comparison of one year's charges with the other. From that we arrive at a fair conclusion as to whether they are reasonable or consistent—whether they are fluctuating too violently. The purpose is to bring out that you are charging to repairs everything you should and not to some other account, and that you are using the same basis consistently from year to year, so that when we do make a comparison of the various charges from year to year we are making a consistent comparison.

No. 16. (b)3—The mere fact that you answer that question and that the taxpayer answers it by saying, yes, there has been an abnormal expenditure, it was $100,000, does not mean that he ought to capitalize it, but we may say he ought to have capitalized some of it.

No. 16. (b)4—In other words, have you written off anything you should have capitalized? Once again, let me say it is not an unusual practice in some lines of industry.

No. 16. (c)—I do not think it is necessary to enlarge on that. The question is there because we in the income tax division are charged with administering the wartime salaries order, and it is up to us to see that those who have increased salaries have the necessary authority to do so; we ask the taxpayer to furnish us with particulars of the

increases made, and to state when he got authority to make them.

No. 16. (d)—In other words, has the president got his wife on the payroll, or his son going to university? Once again, that type of charge is not unheard of. (Laughter)

No. 16. (e) and (f)—We do find, not infrequently, that certain personal accounts have been paid for executives, and somehow or other these executives never got around to pay this back, and the company, in a streak of generosity, says, "Oh, well, let's write that off." We want to know. (Laughter)

No. 16. (f)—A good many of you gentlemen know that that is not an unusual practice. There is nothing unusual about a chief executive being granted an annual allowance for expenses, and no one asks him to report back as to what he did with it. Well, perhaps the corporation is not interested, but we are, because if he did not spend that money on company business and cannot satisfy us, he should pay tax on it.

No. 16. (g)—That is simply a case of bringing charges of that kind out into the open and setting them out in detail so that we know what they are and can follow them up to find out if they are reasonable. If they are not set out specifically, we do not know anything about it.

No. 16. (h)—That question is there simply because we do not allow salaries in excess of $14,000 to non-residents, unless the non-resident pays tax on the salary.

No. 16. (i)—Any of you who are familiar with pension plans will appreciate that; and the reasons for the questions will be perfectly obvious without any explanation on my part.

No. 16. (j)—There is, as you all know, a limitation on the amount of donations to be allowed, the percentage-maximum; and we simply want to know if the amount charged is in excess of that allowable amount.

No. 16. (k)—I suppose you are all familiar with the fact that advertising has been more or less to the fore in the last year or so—I think necessarily so because there has been a tendency on the part of some corporations to spend money on advertising that, to our minds, is abso-

lutely unnecessary and unproductive; they find money to spend on billboards, and so on, and if a limitation was not put on that there could be an awful lot of income tax and excess profits tax going out in advertising.

No. 16. (l) 1—That, of course, is a question of fact. Is the price juggled from year to year so that you are absorbing the loss of one subsidiary, or what are you doing about it? And as to the sales of equipment between companies, are they sold at enhanced valuations — enhanced appreciations?

No. 16. (l) 2—That, of course, is just a question of consistency.

No. 16. (l) 3—Well, No. 16 (g) dealt with allowance paid to non-residents. This question has to do with associated domestic companies. The information is the same as called for in 16 (g), and for the same purpose, of course.

No. 17. (Extraordinary Expenses)—In other words, if you have any extraordinary charges of that kind, bring them out in the open and let us have a look at them; that is all there is to that question.

No. 18.—This, of course, is the certification by the officials of the company.

Chairman: . . . . The next part of the questionnaire is going to be handled by Mr. Grant Glassco. Mr. Glassco is the Ontario representative on the Dominion Association legislation committee. He has worked along with Mr. Mapp and other members of that committee in co-operating with the government in the drawing up of this questionnaire, and is quite familiar with it. Mr. Glassco is also chairman of the Taxation Committee of the Ontario Institute; so, you will see that he is just steeped in taxation matters.

Mr. Glassco's Remarks

Mr. Glassco: Gentlemen, the purpose of Section 19 will be evident to you all. It is to give the income tax department a picture of the extent to which the report which is required may be taken to substantiate the questions answered by the taxpayer.

I think in reading Section 19 it must be very carefully kept in mind that the whole of the questionnaire up to this point is essentially a reply by the taxpayer to the questions asked by the department.

I shall read Section 19, and then I shall speak about the report which has been distributed, and which has been prepared in the belief that a draft of that sort would be helpful to the members as an indication of the length and completeness which would be required in order to meet the views of the department.

(a)—The purpose of that, I fancy, is obvious. If you have to speak of a questionnaire or submit a report saying it is essentially correct, you should obviously have a copy properly signed in your file.

(b)—A number of corporations, particularly perhaps the smaller ones and some subsidiary companies of foreign corporations, make a practice of appointing as their auditor an employee or someone who may be an employee of an affiliated company; and the department wants to know what the status of the auditor is.

(d)—I think in reading that it is very easy to get the impression that a very full statement is required from the auditor. I have no doubt that without some guidance in that direction there will be some who will fall into the error of trying to answer the questions already answered by the taxpayer. In discussing this report, therefore, we should bear in mind it is essentially a description of what we did, not a statement of the facts.

One point—we must qualify our certificate or report if we come to the conclusion that the answers made by the taxpayer are not proper in every respect, and that, of course would prove very embarrassing. The form provides that in such case we are to draw to the attention of the department such of the taxpayer's answers as we cannot endorse.

This draft report which I shall now discuss is an imaginary case. You will see as we go through it that alternative statements might well be made. It is essentially a small company. It is a test audit, and the variations which will be required for other classes of companies and other classes of audits will be apparent; and I have no doubt the same report, or a similar report of the same category, could be prepared in much better shape. Bear in mind it is only presented as a guide.

SPECIMEN OF THE REPORT OF THE AUDITOR REQUIRED UNDER SECTION 19 OF THE T.2 QUESTIONNAIRE RE BLANK MANUFACTURING COMPANY LIMITED

1. We are the auditors of the above mentioned taxpayer.
2. We are conducting a professional practice as public accountants and auditors under the name of John Smith & Company, Chartered Accountants, Toronto, Ontario.
3. *Scope of examination*

Our audit consisted of an examination of the accounts at the year-end for purposes of verification of the balance sheet at that date supplemented by a review of the accounts for the year, and a test examination of the transactions of two months within the year.

Our report to the shareholders on this examination was submitted under date of 2nd March 1943.

We comment on our examination of certain assets and liabilities as follows:

Assets and liabilities (Items 6-15)

(6) Investments on hand at the year-end were verified by certificate from the bank with which the securities were lodged as collateral. All acquisitions and disposals of investments during the year were audited by the examination of vouchers, contract notes or other evidence.

(7) Accounts and bills receivable — A circularization of the company's customers was made for the purpose of confirming the outstanding balances at 30th November 1942. The year-end verification consisted of examining the accounts, analyzing and ageing the balances of both accounts and bills receivable and discussing the accounts, particularly all overdue items, with the management.

(8) Deferred charges — The calculations of the deferred charges and prepayments made by the company's officials were scrutinized by us.

(9) Inventories — We reviewed with the management the basis of taking and valuing the inventories at the close of the year and obtained the usual certificate from responsible officials.

No physical examination of the inventory was made by us.

The inventory tally sheets and final summaries were compared and the additions and extensions checked throughout.

The pricing of the inventory was verified by the following tests:

Raw materials—by comparison with suppliers' invoices —extent of test 55% of total value.

Work in process and finished goods—by reference to the company's cost records—extent of test—work in process 20%, finished goods 37%.

In addition inventories were scrutinized and compared with the previous year's inventories to disclose slow-moving and obsolete stock, and current selling prices were, in certain cases, compared with inventory values.

(10) Fixed assets—All additions and disposals during the year were audited in detail as were all changes in the depreciation reserves.

(11) Current liabilities—Balances owing to the larger creditors

were confirmed by correspondence. A certificate was obtained that all liabilities were reflected by the accounts and we took reasonable precautions to verify that such was the case. The company's calculations of accrued liabilities were scrutinized by us.

(12) Bonds, funded debt, etc.—The taxpayer has no such indebtedness.

(13) Foreign exchange—All foreign exchange computations have been reviewed by us.

(14) Surplus—Dividends paid were verified by reference to the director's minutes.

(15) Capital stock—The outstanding capital at the year-end was verified by correspondence with the Blank Trust Company registrar.

Profit and loss account

The audit of the operations consisted of a review of the accounts of the year supplemented by a test examination of accounting records covering the business of two months.

4. In addition to the examination outlined above, we have reviewed with the subscribing officials of the company their answers to the questions in Form T.2 questionnaire of the company and, subject to the limitations in the scope of our examination herein referred to, we report that to the best of our knowledge and belief the questions therein are properly answered.

"John Smith & Company."

1.—The question arose during the discussions as to whether a professional accountant, other than the corporation's own auditor, should be permitted to sign this report. Some corporations have the habit of consulting accountants other than their own auditors, on tax matters. The department wants this certification from one who has the knowledge that is gained through the audit of the accounts; and even should a taxpayer have no professional auditor but should go to a professional accountant for tax advice, there is no provision whereby anyone but the auditor of the corporation should sign this report.

3.—Reference is made to the report which has been made by the auditor under the statutory requirement. The second paragraph in many cases will refer only to the auditor's so-called certificate which appears at the foot of the balance sheet, but it draws attention to the fact that a report has been submitted to the taxpayer.

3 (6)—They might have been verified by count; they may have been lodged for safekeeping.

3 (7)—This is a January year. Someone else's routine on examination of the accounts might be totally different, but a brief statement indicating how far the auditor has gone is what the income tax authorities require.

3 (8)—In other words, it is not necessary to describe how those computations were made. The client has been asked to answer the questions dealing with that item. All we need say is that we did scrutinize them. So that our statement that the question has been properly answered bears some weight.

3(9)—Someone else will have tested it; someone else will have tested all the items over $1,000. A brief statement to that effect will be sufficient. It may not always be possible to indicate by percentages the extent of such tests, but this is simply an illustration of one way in which the extent of the work done by the auditor may be conveyed to the department. Again, an alternative basis of examination may be referred to, such as an examination of all important items, or all items over a certain amount —or possibly only a substantial test.

3(14)—If there are other surplus charges or credits, some reference will have to be made—probably a statement that they were examined or scrutinized will be sufficient.

Profit and Loss Account—Now, the test as to whether or not this is a good answer depends upon the impression which it creates in the mind of the reader as to just how much work the accountant has done.

I think Mr. Gibson will bear me out when I say that the whole purpose of requiring such a statement is that the income tax authorities should know whether the inspection in each case has been a casual or a thorough one.

Questions and Answers

A Member: Should the report, when we have finished it, be handed to our client, to the tax collector, or do we file is direct ourselves?

Mr. Glassco: There seems to be a little disagreement about the answer to that question. The question was, when the auditor has completed his report does he forward it to the government or send it to his client.

I think the auditor's report, being required to accompany the taxpayer's return, will have to be completed by the auditor and forwarded to the client; because technically the client—the taxpayer—files the T.2 Questionnaire.

In practice, I fancy very often the client may look to his auditor to take the completed questionnaire from his hands, add the auditor's report, and send it in. I do not

think the technique is very important, so long as they go in together.

A Member: What does the government propose to do with regard to the inevitable stampede of small corporations to surrender their charters?

The Chairman: I think that is a problem for the Province of Ontario.

A Member: Has your committee given any thought to any non-incorporated firms filing a similar return to this?

Mr. Glassco: The form does not require to be filed by unincorporated businesses. The difficulty of extending it beyond corporations will be manifest, because you get into the realm of partnership, and all sorts of problems which would invalidate a lot of the questions in the return. I fancy that if the department would find it desirable to ask such questions of such businesses it will require another form; but this one is explicitly designed for corporation taxpayers.

Mr. Mapp: The department is now considering a form for the unincorporated company—not for everyone, of course, because it would not want to include every corner grocery store; but the commissioner has in mind extending it to unincorporated companies and leaving it to the judgment of the income tax inspector as to whom the form should be sent to obtain the particulars required.

A Member: In the case of an incorporated company that has no auditor or has no audit made, I presume the taxing department will accept the questionnaire signed by the proper officials, without the audited certificate of the company?

Mr. Gibson: I think I can reply to that by saying we will not accept it in the same way as we would the certificate of a reputable chartered accountant. We will investigate the return.

A Member: When are the forms likely to be mailed or made available to the client?

Mr. Gibson: They are available now.

A Member: Is the questionnaire expected from insurance companies and trust companies, for example?

Mr. Gibson: It will not apply to insurance companies; they are assessed on a special basis. It will apply to trust companies and all other types of financial companies.

A Member: As every accountant knows, the valuation of inventories is at cost. Now, there are various methods of arriving at cost. I want to enquire whether the word "cost" as applied under the inventory heading 9(c) will give complete disclosure under those circumstances without going very far.

Mr. Glassco: I think the question in essence was, is it required that this be dealt with in such detail as to disclose exactly how cost has been determined. And I think Mr. Gibson's view is certainly that the answer is yes. The Department wants to know exactly how cost has been arrived at.

A Member: No. 19 of the form is an onerous duty on the auditor if we do not put in "according to the information given". Now, do you not think we should state in there that it is according to the information and explanations given?

Mr. Glassco: The question is, as to the final part of the auditor's report where we say that we report that to the best of our knowledge and belief the questions therein are properly answered—whether that is dangerous, in that we do not qualify further by saying that it is also subject to the information and explanations we have received. I would think that the phrase which is employed, "to the best of our knowledge and belief," would protect any statement which was made in good faith under that heading.

A Member: Is the T.2 Form still required within four months of the close of the financial year?

Mr. Glassco: Mr. Gibson says Yes.

A Member: From the evidence we have before us, do we know what form the T.2 Questionnaire, 1943, will take, or what form it will take in 1944 or 1945, or what elaboration may exist under a different board, a political party, or government that may or may not come into power?

The Chairman: I rule that question out of order.

A Member: No. 16 (f) requires the listing of any allowances for travelling expenses, and so on. Possibly the executive might consider that proper accounting had been made; but how detailed would you expect an accounting to be?

Mr. Glassco: How detailed an accounting has to be sub-

mitted? I think the main requirement shall be that an accounting is made, even if it is a very brief accounting. In practice many senior officers of corporations do not keep minute details of their travelling expenses. The essential condition is that the officer should state how much he has spent and refund the balance.

A Member: In this specimen of the report of the auditor, in No. 3, there is a reference to the date of the report to the shareholders. It is not uncommon to also submit reports in somewhat more detail to the directors of the company; if there is such a report in existence should not the detailed report also be given in the auditor's report?

Mr. Gibson: It has always been my impression that that report should come with the tax return; but it is my experience that it rarely comes with the tax return, and when I have endeavoured to get copies, I would not get them. My experience is we rarely get those reports; we are told there is information in them that is not our business.

A Member: In connection with reserves, is it the auditor's responsibility to include in his report mention of any reserves which the taxpayer has not disclosed in answer to the questionnaire—where the business policy may be sound, but which would not be allowed by the Tax Department?

Mr. Gibson: The answer, obviously, is Yes, if he is to give a proper report, because the auditor is reporting on whether or not the questions are properly answered by the taxpayer. The taxpayer is asked whether or not he has charged any reserves of that kind, and the auditor, naturally, if he has knowledge of that, must say so, to my mind.

A Member: There are occasions when auditors are appointed by the directors, before any shareholders' meeting is held. How does an auditor stand in that case?

Mr. Gibson: I will be frank in saying I do not think the question has been considered, but my thought would be that the auditor appointed by the directors could certainly file the report that is required.

A Member: Would not the bookkeeper of a small family corporation be enabled to sign the questionnaire?

Mr. Gibson: I think the answer is yes, if there is no one senior to him in the accounting work he is obviously chief accounting official and has the right to sign.

A Member: A very practical point comes up. This is being applicable to December 31st, 1942 and all subsequent periods. We all know that, particularly with out of town engagements, a good many of these balance sheets have already been drawn up; further, because of the intimacies of this questionnaire undoubtedly the client will put the responsibility on us. We may only go out of town once or twice a year. Who is going to pay for the additional travelling expenses and time?

The Chairman: I am afraid there is no one on the platform competent to answer that question at the moment.

A Member: Does this questionnaire apply in the case of small personal corporations? And I have in mind a difficulty, right now. I am the auditor of two personal corporations. The books of those corporations are kept in my office. There is no chief accounting official who can sign those books, other than myself as the auditor. It never changes from year to year, this particular personal corporation; in other words, it is just a holding company in the other personal corporation. Would a blank return in that case be accepted, because there are no questions here that would apply?

Mr. Gibson: Under those circumstances all you could do is to file a T.2 Questionnaire with a memorandum on it to the effect that none of the questions is applicable to that corporation.

The Member: How about signing it when there is no official of that company who has any details of it?

Mr. Gibson: Sign it yourself; that is the only answer I can give.

A Member: Supposing this questionnaire involves a second visit to the client's office to complete the questionnaire and the auditor puts in a separate fee for that additional work, would that charge be allowed for income tax on excess profits?

Mr. Gibson: Unless I am mistaken, you gentlemen have for years been collecting fees, or should have been, for the preparation of income tax returns, and I do not think we have ever questioned the allowance of those fees. I do not think we will question them now.

A Member: If a party's remuneration is a fixed salary

plus percentage of profits, will he have to report under Section 16 (c) of the questionnaire?

Mr. Gibson: Under the circumstances, in a case of that kind it is necessary to declare under the war-time salaries order the fact that the man does have a contract; and so I think the information should be given here.

A Member: Under 16 (c), whether the wages come under that or not, has a ruling to be obtained from the War Labour Board?

Mr. Glassco: I think the answer is, that if the company does not know, it may ask the War Labour Board. In practice, most companies have found out most of those employees who are subject to the wages control order.

A Member: Reference was made to an affiliated company and subsidiary companies. Am I right in my presumption that if a consolidated return is being filed, the T.2 form will have to be filed on behalf of each subsidiary company?

Mr. Gibson: Yes, because in effect when we assess the consolidation we determine the profit and loss of each one separately and would require to deal with each one separately; and so a T.2 questionnaire would be required.

A Member: In the case of an audit of a company having auditors, with branches where detailed operations are carried out, such as a coal mine, having auditors at head office, there being two separate audits, the questions in connection with operations necessarily have to be answered by the auditors at the mine, whereas there are other questions which will be answered by the auditor at head office. Would the procedure be to file two T.2 questionnaires, one accompanied by a report of the mine auditors, and one accompanied by the report of the head office auditor?

Mr. Gibson: The form calls for the report on the questionnaire to be signed by the auditor appointed by the shareholders, and while I am very rusty on company law, it is my recollection that the shareholders appoint only one auditor or one firm of auditors, and it must be that auditor who signs the report to the company's questionnaire. If that auditor cannot give complete details as to operations, he cannot, that is all.

HIGHLIGHTS OF AUDITING AND BALANCE SHEET PROCEDURE*

By H. C. Dell, Chartered Accountant, Toronto

YOU have listened to a series of lectures on bookkeeping, auditing the detailed records of a business, and the preparation of financial statements and working papers. The primary purpose of all these lectures has been to explain to you the reasons for performing the work that you do from day to day. We feel that if you know *why* you are doing your work it will not only be much more interesting to you, but you will also perform it more intelligently.

Before going further I would like to remind you that the office folder on auditing procedure with which you have been supplied has been prepared to indicate the minimum auditing requirements needed to conduct an audit of the affairs of most clients. Please remember, however, that it represents a minimum only and that in many cases where there are unusual circumstances considerably more work must be performed. The office folder was not written to explain the reasons certain auditing procedures are necessary; to tell you why these procedures should be followed has been one of the main purposes of the lectures that you have been attending this week. If you have any difficulty understanding why certain procedures are specified in certain cases, do not hesitate to seek an explanation from one of the senior men in the office.

Internal Check

Throughout the various lectures the phrases "internal check" and "internal control" have kept appearing and reappearing. This is because the amount of auditing work which we conduct in any client's office usually bears a very definite relationship to the adequacy or inadequacy of the system of internal check and control in operation in that client's office. No lecture was given on this highly important subject and I would like to spend a few minutes discussing it before beginning a review of the material covered during the series.

Internal check has been defined as "the co-ordination

*This is the fifth and last of a series of lectures relating to the subject of Staff Training. For reprints of the series, see announcement on outside back cover of this issue.

of the system of accounts and related office procedure in such a manner that the work of one employee independently performing his own prescribed duties checks continuously the work of another as to certain elements involving the possibility of fraud or error". Internal check implies that some fact has been verified by two independent methods or persons, so that the responsibility for the accuracy of that fact has been assured from two independent sources. Collusion results from two or more persons working together for purposes of committing a fraud and while it is true that occasional examples of collusion are found, an analysis of a large number of cases of fraud shows that in not more than ten per cent of them was collusion a factor. Thus, if we satisfy ourselves that the system of internal check and control is effective, not only in theory but in practice, we may feel fairly confident that the chances of fraud being perpetrated have been substantially reduced.

For these reasons the system of internal check and control in a client's office should be reviewed each year before we decide on the audit programme for that year. The audit programme should then be designed to prove that the theoretical system of internal check and control is actually operative and it should also be directed at those sections of the client's records where the internal check is relatively weak. Such a review not only provides the auditors with a general knowledge of the accounting procedure and personnel as a basis for defining the scope of his examination, but also determines whether accepted principles and methods are being consistently followed, and whether there are weaknesses in the organization methods and internal audit which invite irregularities either by the management or by employees.

A review of the internal check and control should not be mere looking around or random questioning but should be systematic, deliberate, continuous and comprehensive. There are the following reasons for preparing a written record of the review—

1. It proves that the test checking employed by the auditor in the case of any individual client was scientifically planned to meet the requirements of that particular client's organization and accounting system and was not determined in a haphazard manner.

2. It provides the partner or senior who reviews the working papers with the information necessary to decide whether the examination has been adequate.

3. If litigation should arise out of irregularities that were not discovered during the course of the audit the written record provides the best possible evidence to support the auditor's testimony in court. This is of particular importance when the litigation requires the auditor's testimony many years after the date of the engagement.

4. It provides an excellent memory refresher for the senior in charge at the beginning of each recurring examination. If the senior is new on the engagement it has a very definite educational value.

The duty of reviewing the system of internal check and control in a client's office falls to the senior in charge of the audit. For this reason we may deal very briefly with the method employed in making the review.

The first problem is to determine what are the valuable portable or negotiable assets of the client, such as cash, securities, receivables, inventories, etc. The review will then be classified according to these assets and indicate their receipt by the business, their flow through the business and their final disposition, whether it be their conversion into other assets or their flow out of the business. The review will have as its major objective the determination of how effectively the system of internal check and control and accounting procedures accounts for these assets.

In a manufacturing business, for instance, in considering the inventory a brief flow table would be prepared showing the request for materials being sent to the purchasing department, the purchase order being given, the goods being received, the goods going into stores, the flow of material through the business into finished stock, the order being received for sales, the goods being shipped and invoiced and their conversion into another asset such as accounts rceivable or cash. Such a flow table would indicate the several points at which trouble might occur, and with this in mind the senior in charge should review with the proper officials and employees the internal check which purports to be in operation in the client's office, and make rough notes thereon on the flow table. The next step should be to ascertain if the theoretical system outlined by the

officials and employees does in fact work in practice. This will be done by finding out from the employees doing the work whether their practice is what their executives think it is. This information will be further verified by incorporating into the audit chart a series of questions on each section of the work to ascertain that the controls and checks actually work in practice. It is in this latter part of the work that you are most likely to be of assistance to the senior in charge.

The cost of doing a complete detailed audit of the transactions of a business is not warranted or necessary where the internal check and control is excellent, even though it may not be perfect (as it is always possible, although improbable, that there may be collusion between several people). For instance, if the cashier does not have access to the receivable, shipping or billing records, if the receivable clerks have no access to the cash, shipping or billing records, if the invoicing clerks have no access to the cash, receivables or shipping records, and if the total of the daily billing as shown in the sales recapitulation is agreed with the total of the postings to the accounts receivable ledgers and someone not otherwise connected with that particular section of the business ascertains that consecutive numbers on shipping records are all accounted for as having been billed, there is no good reason for spending money on auditing the sales records. The thing to be done in this case, and it is most important that it be done properly, is to ascertain that the theoretical internal check as outlined above actually works in practice and that there are no short cuts allowed which permit the cashier for instance to post the receivable ledgers or help on the sales recapitulation if he wishes.

If the accounting records of a company are poorly kept, and if there is no internal check, there is a very definite possibility that even a complete detailed audit may fail to disclose fraud. It is for this reason that we insist on writing to our clients to point out where their system of internal check is weak and to make recommendations that would strengthen it. It is not a coincidence that, where the internal check is poor and where the client refuses to remedy the situation because he believes all of his employees are honest, eventually fraud almost invariably occurs. We

have had a recent example of this, where a fraud was discovered in the office of a client to whom we have been writing almost annually making suggestions that his internal check be improved and pointing out that he had failed to do anything about our recommendations made in previous years. Since the discovery of the first fraud in this client's office, three additional people have been found guilty of defrauding the client. As far as we have been able to ascertain, and according to the statements of the defrauding employees, none of them was acting in collusion with any of the others; the reason that so many frauds occurred in this one office would appear to be entirely due to the fact that the system was so lax and the internal check so inadequate that almost any employee of the company could steal its funds without any great fear of being discovered.

Bookkeeping

In your first lecture you were taught the underlying principles of bookkeeping. In this profession we are not bookkeepers, but auditors, and as auditors it is necessary that we know more about bookkeeping than bookkeepers know. Accordingly, if you wish to become a good auditor it is essential that you know enough about bookkeeping to be a good bookkeeper.

Bookkeeping has been defined as "keeping track of business transactions in an orderly way and in terms of dollars and cents". Business transactions normally consist of buying and selling goods and receiving and paying cash, and all of these transactions can be measured in dollars and cents and are entered in various books of original entry as soon as or very shortly after the transactions occur. The information contained in these books is then posted to ledgers under the name of each person, account, etc., so that all of the transactions are summarized therein.

Double entry bookkeeping has been found to be the only satisfactory way to record properly the transactions of a business and under this system the debits and credits must be equal. Whether an item is a debit or a credit is most easily determined by remembering that the books of a business show the relationship of that business to the outside world. Thus, if someone owes the business money that person has a debit balance on its books; in other words he

is its debtor. If the business owes someone money, then that person is its creditor and will have a credit balance. When a business issues a cheque in payment of a liability which has already been recorded in its books, it reduces the liability to the creditor and also reduces the indebtedness of the bank to the business; the entry therefore is—Debit accounts payable, Credit bank.

At the end of an accounting period a trial balance is taken of the ledger accounts and by balancing indicates, but does not guarantee, that the work has been accurately performed. The trial balance is then used to prepare the balance sheet and operating statements of the business.

Audit of the Detailed Records of a Business

You have attended several lectures which outlined in detail the method of conducting an audit of the records of a client and had explained to you the types of fraud which occur most commonly and how these may sometimes be detected as a result of correct audit procedure. It should be remembered, however, that the responsibility for safeguarding the funds and other assets of a business rests primarily with its officers or executives, whose duty it should be to see that the accounting system is designed to keep proper account of the assets and also see that it is functioning efficiently. The officers and trusted employees may of course be dishonest and for this reason it is wise to carry fidelity insurance as a protection against these or other employees who may be in a position to misappropriate assets of the business. We cannot undertake to ensure a client against fraud nor can we undertake to detect fraud even where we do a detailed audit of the accounts, which as you know we do not do in most audits. We are not insurers and we recommend to our clients that they carry adequate fidelity insurance at all times to reimburse them if they should be unfortunate enough to suffer a loss through the dishonest action of their employees.

Additions—The problem of additions is one that occurs in every record that we audit and no doubt many of you think it is somewhat overdone. This is not true as practically any fraud committed could be covered by manipulating additions if the defrauder thought that the additions of the books would not be rechecked. You might consider that your proof of additions is the cement that holds to-

gether all of the other audit work that is performed, for unless the additions are properly checked, the entire value of all of the other auditing work might be completely lost. We might spend hundreds or even thousands of hours checking a client's transactions in great detail but unless the additions were also proved we would not know that the final answers shown in the client's records were correct.

Innumerable examples might be given of frauds committed through additions, but one or two should suffice. In one case where the cashier was stealing funds it was his procedure to enter the receipt in the cash book in the accounts receivable column, but to omit it in his deposit. This meant that if the additions had been correct the book would not have cross-added at the end of the month and the general ledger would have been out of balance. To prevent this he understated the total of the accounts receivable column to the extent of the money stolen, and in this way the totals in the cash book cross-added and the general ledger balanced. This particular fraud was discovered by the audit clerk who found that the accounts receivable column would not add in the cash book, nor would the cash book cross-add at the particular date selected in the middle of the month.

Another method of covering up a cash shortage through the manipulation of additions is to enter the amount stolen in the cash receipts book, show the deposit for the actual amount put in the bank and bring the books into balance by over-stating the additions of the cash discount column.

Postings—Postings must be checked in connection with many of the records audited and the problem here is similar in many ways to that of additions. Almost any fraud could be covered through errors in posting and if postings were not properly checked all the other audit work might be in vain.

Cash on hand—The majority of fraud cases involve misappropriation of cash and the detection of fraud is therefore one of the major objectives in the audit of cash transactions. The first step in verifying cash consists of counting the cash on hand and balancing the count with the client's records. The essential features of cash counts may be briefly summarized as follows:

(1) All cash must be counted at the same time. Al-

though it is not always physically practical to count all cash at the same time, all cash must be kept under your control until all of the funds have been counted. If you did not control your cash in such a manner, after one fund was released it might be used to make up a shortage in another fund which you subsequently counted.

(2) The surprise element. To be really effective a cash count should come as a surprise to the cashier; otherwise he might be able temporarily to cover up a shortage over the period of the count. Cash counts at the balance sheet date do not come as a surprise and for this reason we should make a surprise count of the cash of all clients, where possible, at least once during the client's fiscal year.

(3) Time of day to count. Whether the cash count is a surprise or not you should select a time of day when the cashier is not busy handling large amounts of incoming funds, and it is usually preferable that the cash be counted after the day's banking transactions have been completed. At the balance sheet date the best time is at the close of business on the last day of the fiscal year, or failing this, the first thing the following morning. If the count is left until a later date, it is not as satisfactory and considerably more verification work needs to be performed in order to work the count back to the date of the balance sheet.

(4) If no cash on hand. Even if there is no cash on hand, there is audit work which must be performed at once in order to verify the fact that no shortage exists. In the lecture on cash the procedure that should be followed even when you are informed that there is no cash on hand is set out in detail. If this work were not performed at the time of the count, it might be possible for a defrauding cashier to take the subsequent day's receipts and show them as an outstanding deposit in order to balance his cash.

(5) Do not be left alone during the count. It is a cardinal rule of auditing that a representative of the client must be present at all times when you are counting the client's cash or securities. If an employee of your client were short of cash, or securities, and left you alone to count them even for a short time, he would be in a position to state that the cash and securities were in order when they left his control, and that if there was any shortage you must have been the one who did the stealing.

There is an excellent example of this happening in a bank where a bank inspector (who certainly should have known better) was left alone counting the teller's cash and when he found it was short approximately $50,000, the teller swore that his cash was in order and that the inspector must have stolen it during his absence. Despite the fact that the inspector insisted on being searched and did not have the $50,000, there was no proof that he could not have disposed of it while the teller was out of the cage and it placed him in a most embarrassing position. I know that none of you would wish to be placed in this position and your only certain way is always to insist that you must not be left alone with a client's cash or securities.

(6) Balance the funds at once. All cash counted must be balanced at once and this must not be left until a later date. If there is an apparent shortage you should make sure that the cashier agrees with your count before you leave the client's office; otherwise he may have an opportunity to obtain funds elsewhere to balance his cash and claim that you must have overlooked some at the time of your count. Any apparent shortage must be reported to your staff senior at once or if your staff senior is not available for any reason, to some other senior in the office. The work to be performed in balancing the cash is set out in considerable detail in the lecture on cash and I will not repeat it here. I would like to emphasize, however, the necessity of performing the work indicated therein at the time of the cash count. If this work is not done at that time, the cashier would have an opportunity to cover any shortage by adjusting his books between the date of the count and the date of the detailed audit.

(7) Check details of count to records. It is extremely important that the details of the cheques, etc., included in the cash counted be checked to the cash and other books and to the deposit slips, although this work may be left until a subsequent date if necessary.

(8) Petty cash. If the petty cash is on an imprest basis it is not usual to keep a petty cash book and the amount of the count should agree with the ledger account. If the count is not performed on the balance sheet or reconciliation date but in the middle of the month, we must see that the fund has not been increased or decreased since

the ledger was last posted. This can be done by scrutinizing the cash disbursements and receipts records for the intervening period. If the fund is not on an imprest basis the vouchers are usually entered in a petty cash book and the balance will vary from month to month. If the count is made at a balance sheet or reconciliation date, it must agree with the general ledger balance. If the ledger has not been posted up to date at the time of your count it will be necessary for you to add the petty cash book, cross-add the totals and reconcile with the ledger balance. Complete details of how to prepare this reconciliation appear in the lecture on cash.

Banking transactions—The current audit of the banking transactions is usually the first major audit function assigned to a new clerk after his or her initial training period. This indicates a belief on our part that this work can be mastered in a relatively short time by an intelligent person. It must not be taken to mean, however, that we consider this work to be unimportant as nothing can be further from the truth. It is absolutely necessary that you understand perfectly how to perform this extremely important work; and only by careful repeated study of the auditing instructions which you have, can you become thoroughly familiar with our procedure. I will not attempt to review all of the points which you should cover in your audit programme but only certain of the more essential ones.

(1) Examination of cheques. The following are the important things to watch for when you examine a cancelled cheque—cheque currently dated, body and figures in agreement, proper signatures of signing officers, bank cancellation stamp currently dated, proper endorsements and redeposited cheques. It is unnecessary to tell you how a proper endorsement or a bank stamp should appear; the important thing to remember is that a forged signature, forged endorsement, erasures on that part of the cheque bearing the name of the payee, figures or endorsement, bank stamp bearing a date not within the period under audit, second or third endorsers who are employees of the client, etc., may all be indications of fraud and may all accomplish the same purpose.

After a cheque has been made out to a creditor it may be discovered that it is for the wrong amount, or that for

some other reason it cannot be sent to the payee. It is customary to include such a cheque in the company's own deposit and mark it "redeposited to cancel" instead of crossing out the entry in the cash disbursements record. All such cheques should be traced by us to make sure that they are entered in the cash receipts book and credited to exactly the same account to which the corresponding charge was made in the cash disbursements book.

(2) Debit notes. These are much more easily tampered with than cheques, and for this reason they should be checked to the bank statement to see that they are properly marked as such thereon. Debit notes for large amounts (say $50 or more) should be signed by the authorized signing officers of the client in the same way that cheques are signed to indicate the officers' knowledge and approval of the withdrawal of funds.

(3) Bank and bearer cheques. Cheques made payable to bearer, to a signing officer, or to a bank should be indicated as such in the cheque register, so that the disposition of the cash received from such cheques can be traced as having been used for a legitimate purpose. If this were not done, it would be possible for a cashier to issue a cheque payable to a bank and then instruct the bank to issue a draft in favour of himself or to someone from whom he could obtain the funds.

(4) Deposits. Deposits as recorded in the cash book should be traced to the bank statement and there should be no time lag between the dates appearing in the cash book and on the bank statement. Such a delay might indicate that the cashier was short in his funds and was using subsequent receipts to make up the required previous daily deposit. At a balance sheet date an outstanding deposit must be verified by actual count. If the cash is not counted at the close of business on a balance sheet date it must be counted as soon as possible after that date. The cash book must be balanced at the latter date and all deposits subsequent to the year-end up to the date of the count traced into the bank.

(5) **Bank reconciliation.** When the cheques have been examined and the deposits checked to the bank statements, the actual work of reconciling is quite simple. The outstanding cheques as shown in the cash disbursements book

and on the previous bank reconciliation will be listed, the outstanding deposits will also be listed, and the balance as shown on the bank statement or confirmation reconciled with the ledger balance as follows:

Balance per bank	....
Add outstanding deposits	(Total)
Less outstanding cheques	(Total)
Balance per ledger	....

The following items are very important and should not be overlooked:

(a) The bank columns in the cash disbursements and receipts must be added immediately after the cheques and deposits have been called and the totals must be posted and added in the general ledger at once even though the balance of the ledger is not to be completely posted until a later date.

(b) "Marked" or "certified" cheques outstanding at the date of reconciliation must be noted and followed up at a subsequent date. If any marked outstanding cheques have been outstanding for some time you should ascertain from the bank that these actually are outstanding and have not been returned to the client, whose bookkeeper or cashier might have purposely destroyed them.

(c) The reconciliation should be added and a summary copy prepared for our files before it leaves our control. We should make a note on our copy of any alterations or erasures appearing on the original and at the time of our subsequent visit when we check our figures back to the original, we should make sure that there have not been any additional alterations or erasures.

(6) Examination of bank statement. The opening balance on the bank statement should be checked from the opening reconciliation in our papers, the balances carried forward from one statement to the next and the last balance transferred to the closing reconciliation. The deposit column should be cleared to see that all items have been accounted for and as previously mentioned, the statements should be cleared for debit notes to see that these have all been examined.

The bank statement must be examined carefully for any sign of changes or erasures and if these are suspected the statements should be added and, if necessary, taken to the bank and verified with the original records at the bank. Debit and credit notes should be inspected for all "error

corrected" (E.C.) items on the statement. If these "error corrected" items are large in amount, or appear frequently, the statements should be compared with the originals at the bank, or the bank should be asked to initial these items.

As a test during the year, the cheques for one or more months should be checked to the bank statement to ascertain that the cheques recorded in the cash disbursements book are the same as those appearing on the bank statement. As previously mentioned, cheques are also checked to the bank statement in the month following the year-end or other reconciliation date, as part of the work of verifying the cash balances. The purpose of doing this is threefold—

(a) To obtain any N.S.F. cheques or other charge-backs which might have been used fraudulently to balance the cash.

(b) To pick out any cheques which do not appear as outstanding items at the end of the previous month in the company's records, but which had been issued and possibly also cashed prior to that date and had not been received by the client's bank until after the end of the month.

(c) To detect kiting of transfers. All transfers at the end of a month between the bank accounts of a client must be traced to establish that they are entered in both bank accounts in the same period, or if this is not so, that they appear as outstanding transfers in the bank reconciliation. If these transfers are not so traced, it would be possible for a cashier, who is short in his cash, to include in his deposit on the last day of the month a cheque for the amount of the shortage drawn on another bank account of the client. This cheque would then be entered as a disbursement of the other bank account on the first day of the next month and the cashier would again be short in his cash. Nevertheless he would have covered his shortage over the period in which we counted his cash, and the only way we can make sure this does not happen is to ascertain that all transfers are recorded in the client's books in both bank accounts in the same period.

(7) Vouching the cash books. Where a separate purchase journal or voucher register is kept there are very few items to be vouched in the cash disbursements book, as the majority of the charges are to accounts payable, the vouchers for which are examined when auditing the purchase journal. Similarly, the majority of the credits in the cash receipts book are usually to accounts receivable and no vouchers are required for these entries. It is necessary, however, to vouch the other items in both the cash disbursements and cash receipts books, and the general comments on vouching which appear elsewhere in this lecture apply to the cash books as well as to the other books of original entry.

(8) Posting. A test should be made of the postings of the accounts receivable and accounts payable ledgers from the cash receipts and cash disbursements books. Where an accounts payable ledger is not kept, which is often the case today, the same purpose is accomplished by cross-referencing the payments in the cash disbursements book with the record of the liability set up in the purchase journal.

(9) Duplicate deposit slips. If "lapping" or "kiting" is being employed to cover a shortage it *may* be detected by making a test check of the details of cheques appearing on duplicate deposit slips with the detailed information appearing in the cash receipts book. You must watch very carefully for any changes or erasures on the duplicate slip. As this test is based on the assumption that the duplicate agrees with the original and is not a fake, some of the duplicates tested should be compared with the originals retained by the bank.

Purchase journal—Our object in auditing this record is to see that the entries therein are supported by adequate vouchers properly approved and that the totals are correctly added and posted to the general ledger. The more important points are—

1. Proper voucher. Each entry must be properly supported by an invoice or other evidence of liability. The invoice from the creditor should be addressed to the client, currently dated, give a description of the goods purchased, the quantity, price and total value. The goods should be of a type that it would be reasonable to expect that particular client to purchase. As most of you pointed out in one of the tests it is not reasonable to expect a furniture manufacturing company to purchase a large quantity of lemon jello.

2. Proof that goods or services were received. A receiving slip should be attached to the invoice or the proper person should have initialled for checking the receipt of the goods in the space provided for this on the invoice. If the proper clerk has not signed for receipt of the goods it might indicate that the vendor had not shipped the goods but had billed the company in error, or it might indicate that the goods had been received by some one not entitled to them, such as the company's accountant.

3. Correct price. The invoice should be approved by

the purchasing agent or someone in his department to indicate that the price is correct, that the quantities received were those that had been ordered, and that the cash discount and terms are correct.

4. Arithmetical accuracy. The invoice should be initialled by the proper clerk to indicate that the additions and extensions have been checked. We have often made substantial savings for our clients by scrutinizing additions and extensions on the invoices we examined; in one case I remember we noticed 200 bags of sugar at $6 had been extended and paid as $12,000 instead of $1,200.

5. Proper distribution. The asset or expense account to be charged will be indicated on the voucher and checked by us to the purchase journal. It is not always possible to be certain that the proper expense distribution has been made, but it should at least appear reasonable. Particular attention should be paid to the distinction between capital and revenue items and we should not, for example, permit a client to charge the cost of a brick biulding to maintenance expense. We should also ascertain that personal expenses of employees are not charged to the client's expense accounts.

6. Approvals. The invoice should bear the approval of a department head to indicate that he is satisfied with the charge to his department; it should also receive the general approval of the secretary-treasurer or some similar person to indicate that all other approvals have been recorded and based on his own general scrutiny and knowledge he has passed the invoice for payment.

Accounts payable ledger—The object of the audit of the accounts payable ledger is to see that entries in the purchase journal are correctly summarized under the name of the creditor, that the record is arithmetically correct and that the trial balance of the ledger is correctly added and agrees with the control. Our audit of the postings of the accounts payable ledger is limited to a test and it is essential that the postings in the accounts payable ledger appear in the correct accounts as indicated in the purchase journal and the cash disbursements record. If no accounts payable ledger is kept, cross-checking the entries between the purchase journal and the cheque register accomplishes the same purpose as posting the accounts payable ledger.

Wage records—The payroll is a fruitful source of fraud but due to the voluminous detail it is one of the most difficult records to audit. The usual methods of covering fraud through payrolls involve alterations of rates of pay, incorrect extensions of the amounts to be paid or the inclusion of fictitious names on the payroll. The more important points to watch in doing a test audit of the payroll records are:

(1) Approvals. The payroll should be approved by the foremen or department heads and in addition the entire payroll should carry the approval of the factory superintendent or general manager. This is very important because if two people are in collusion proper time cards, unemployment insurance records, etc. may be maintained for fictitious persons and there would be little opportunity for us to detect the fraud. Although the foremen and plant superintendent may not be in a position to know, without making a detailed review of the payroll, that the number of hours or rates are correct, a rapid scrutiny by them should disclose the names of any persons on the payroll who do not actually work for the client.

(2) Hours worked or goods produced. We should check the time clock cards or time sheets to establish the number of hours worked and in the case of employees paid on a piece-work basis examine the properly approved production records.

(3) Rates of pay. The rates of pay should be checked against properly approved schedules whether they be for time work or piece work.

(4) Arithmetical accuracy. A test should be made of the extensions, deductions, cross additions and additions of the payroll.

(5) Cheques or other form of receipts. When payment is made by cheque we should make a test of the returned cheques and mark them off against the entries on the payroll in the same manner that we audit any other cash disbursements; similarly the payroll bank account should be reconciled in the same way as any other bank account. If the pay is distributed in the form of cash some receipt should be obtained from the employees and these should be tested by us against the payroll.

In order to try to detect any fictitious names that might

be on the payroll, we should accompany the paymaster at least once each year when he distributes the pay, or distribute the pay ourselves if payment is made by cheque, to see that the pay for every item on the payroll is actually handed out to an employee. At the time it is handed out some verification should be made of the identity of the employee by asking him to produce his registration card or otherwise identify himself. Any cheques or pay envelopes which are not handed out on pay day should be controlled by the auditor until the are finally disposed of. The usual procedure for unclaimed wages of this nature is to have the auditor mail out the cheques (or money orders if payments are made in cash) to the employees by registered mail. It is probably self-evident that deliberate errors in extensions, additions, etc. on the payroll could place a payroll clerk in a position to defraud the client and I do not think it is necessary to give you any examples of how this would occur. I would mention one thing, however, which you must watch and that is that none of the payroll clerks should appear as endorsers on payroll cheques other than their own.

Securities—The purchase and sale of securities should be vouched from brokers' contract notes and we should see that the books record correctly the particulars of interest rate, maturity date, par value or number of shares, cost or selling prices, adjustments for accrued interest, profit and loss on sales, etc. Security transactions should all be approved by a responsible official such as the secretary-treasurer or a director who may be charged with the responsibility of watching these transactions. In most cases the transactions should be summarized and recorded in the minutes of directors' meetings.

Securities should always be held under the joint custody of two senior officials of a client, so that one person alone could never be in a position to steal them.

It is very important that we verify that all income which should have been received during the year actually was received on the proper dates; this work is usually done at the year-end.

Sales records—The object of auditing sales records is to see that invoices are recorded for all sales and charged to the accounts receivable records. A common method of

committing a fraud is to omit recording a sale to a customer and when the remittance is received to misappropriate it. A similar result may be accomplished by understating the totals of the recorded invoices. For this reason we should try to satisfy ourselves that an invoice is written and posted to the accounts receivable ledger for every shipment of goods. To accomplish this we should test the shipping records and order files to the invoices, account for consecutive numbers of invoices and see that the invoices are properly recapitulated and posted to the accounts receivable ledgers. If an invoice has been spoiled, we should ask for the other copies to make sure that the duplicate has not been marked "spoiled" and thus not posted to accounts receivable, while at the same time the original has been sent out to the customer whose remittance will be misappropriated when it is received in the client's office.

Credit notes—Credit notes issued for returned goods and price allowances should be examined to see that they are in order. To verify credit notes we should examine receiving slips in the case of returned goods and correspondence in the case of price allowances. All credit notes should be approved by a responsible person. We should account for the serial numbers on credit notes and should inquire of the approving official to ascertain that he accounts for consecutive numbers of all credit notes presented to him.

Accounts receivable ledgers—A test should be made of the accounts receivable ledgers to see that the accounts have been correctly posted and properly added, and that the checked trial balance agrees with the control. The balances appearing in the accounts receivable ledgers should be confirmed by us directly with the debtors at least once each year. This is discussed in greater detail later in this lecture under the heading of "Balance Sheet Procedure".

Stores records—It is often easier for a dishonest employee to steal merchandise or stores than cash or securities, particularly where a company is in a business which involves the carrying of large quantities of valuable merchandise, tools and supplies. Certain types of business are much more subject to trouble in this respect than others. For instance, theft of merchandise does not present the same problem to a producer of iron castings as it does to a manager of a jewellery store.

If no book inventory records are kept the principal protection for the client must lie in the supervision which is provided through gatemen, foremen, etc. If stock records are kept, however, he has a much better check and we should make tests of purchases to see that all debits are posted in the inventory records and of the requisitions and sales to see that all credits in the stock ledgers are properly supported. We may also make a physical count of a portion of the stock during the year and compare it with the amount recorded in the books.

General journal—This record may contain entries affecting any of the general ledger accounts and therefore all entries, particularly those which purport to be adjustments arising out of errors, should be carefully scrutinized and any unusual items brought to the attention of your senior. Each entry should be cross-added separately even though the columns of the journal are totalled, in order to see that the general ledger postings are in accordance with what is indicated in the journal. Entries writing off bad debts should be carefully examined to see that they are approved by the credit manager and, if the amounts are substantial, we should inspect correspondence to satisfy ourselves that every effort has been made to collect the account.

General ledger—This record summarizes the entries appearing in all of the books of original entry and our object is to see that it is accurately written up and added. To do this we check the postings as indicated in the books of original entry, verify the additions and see that the ledger balances. At the conclusion of our audit we should always include in our working papers the trial balance of the ledger at the end of the period audited and this should be checked back to the ledger when we begin our next audit to see that no changes have been made in the ledger in the interval.

Balance Sheet Procedure

Our most important work is the verification of the financial statements of a business. These statements show the position of the business at a given date (balance sheet), the results of its operations for the period (profit and loss account) and the owners' equity in the business (capital and surplus accounts). Financial statements are required by the owners of the business to see what is their financial

position, and by directors and management to ascertain the operating results for periods which are completed and the financial position at the present time, and to try to determine what will be the probable future trend. These statements are also required by bankers and other creditors to see if their debtors are in a solvent condition, and by financial houses and investors to determine the probable worth of an investment.

Verification of balance sheet items—It is essential that you understand the relationship between the current audit of the detailed transactions carried on throughout the year and the balance sheet and other financial statements which are prepared at the end of the year. It is seldom that we make a complete detailed audit of the transactions of a client but in most cases our audit consists of a check of the transactions of two or three months during the year. This, combined with a proper review of the internal check, should place us in a position to know that the company's records present a true and accurate view of its affairs and that the statements prepared therefrom will be correct if we properly verify the existence and value of the various asset and liability accounts.

When we speak of verifying the balance sheet we have in mind satisfying ourselves as to both the existence and the value of each asset and liability shown thereon and if, when you are doing balance sheet work, you consider what is the best way to do this for the particular asset or liability concerned, you should not encounter serious difficulties.

In the remarks that follow I will discuss briefly how existence and valuation should be verified for each of the major assets and liabilities appearing in the balance sheet.

Cash—The problem here is primarily one of existence, which is verified by counting the cash on hand and obtaining certificates from the client's bankers of amounts on deposit with them. The balances shown on the bank certificates will seldom agree with the books of the client and we must effect a reconciliation in the form already discussed, examine the outstanding cheques, prove the deposits and trace the outstanding transfers and in this way satisfy ourselves as to the correctness of the books. Ordinarily the only problem in valuation occurs in the case of foreign

currencies as in this country we do not need to provide for the contingency that a bank might fail.

Receivables—The existence of accounts receivable is ordinarily determined by sending out statements to the debtors asking them to report any differences directly to us. In the case of larger balances we send out positive confirmations requesting the customers to confirm directly to us in writing that the balances are correct. Such a circularization is usually made during the year instead of at the balance sheet date in order that it may be a surprise to the accounts receivable clerk; otherwise he might have an opportunity to transfer any shortage which was resting in his accounts receivable to some other section of the accounts. For the same reason cash should be counted at the date the accounts receivable are confirmed. All accounts which have been paid between the date of the statement and the date of sending out the accounts should be circularized. Otherwise an account which had been paid in the latter part of the previous month might be recorded as having been paid early in the subsequent month and if the statement were not sent out there would be no chance of the debtor whose remittance was withheld having an opportunity of bringing this to our attention.

A trial balance of the accounts confirmed should be checked, added and agreed with the control. If this were not done it would be possible for a clerk to withdraw ledger sheets relating to accounts in which shortages existed.

It is seldom that all accounts of a business are paid in full and we usually must provide for the contingency that a loss will be suffered in the collection of some accounts receivable. To determine what provision should be made for such loss we examine the individual accounts in the accounts receivable ledger and list all accounts that are overdue according to the length of time they have remained unpaid. This list of overdue accounts, together with all large unpaid accounts, are discussed with the credit manager and in certain cases checked to Dun & Bradstreet's credit ratings in order to form an independent opinion of what reserve is required for doubtful accounts. In checking the trial balance of accounts receivable you should see that the account is made up of definite open items as it may be that a customer is paying his current items regularly but

a balance which is in dispute has remained outstanding for some time. An analysis of the continuity of the bad debt reserve during the year should be prepared and all bad debts written off should be approved by a responsible official.

Inventories—Since 1939 auditors in the United States have extended the scope of their examination to include the verification of the quantities of inventories on hand either by test checking the quantities themselves or by accompanying and observing the client's employees while they are taking the inventory count. At the present time it is not recognized as being standard accounting practice for auditors in Canada to make a physical examination of a client's inventories at the balance sheet date unless specifically requested by a client to do this or unless they are verifying the balance sheet of a client whose parent company, or who itself, is governed by the regulations of the Security and Exchange Commission in the United States. We should, however, satisfy ourselves that the procedure which our client follows in taking stock is adequate.

The completed inventory which is priced is usually prepared from original stocktaking sheets and we should make a test of these original sheets to the completed inventory to see that no one in the office has falsified inventory quantities. If the client keeps a book record of his inventories we should test the inventory trial balance to the stock ledger cards.

One of the more important things to do in verifying inventory quantities is to see that the proper cut-off has been made between inventories, receivables and payables. By cross-checking purchase invoices with receiving slips and shipping records with accounts receivable it is possible to determine that goods included in the inventory have been set up in accounts payable and that goods billed and included in accounts receivable have been excluded from the inventory. This point was discussed at length in a previous lecture and I do not think it is necessary for me to do more than emphasize its importance.

Inventories are usually priced at the lower of cost or market value after making proper allowance in the pricing for slow-moving or obsolete stock. Cost to the majority of our clients is determined on the basis of "first-in first-out" or on the basis of "average cost". Generally speaking

"first-in first-out" is the most commonly used method although inventories of supplies are often valued on an average cost basis.

Market price does not mean selling price when applied to inventory valuation. The market value of raw materials and supplies is their replacement cost. The market value of partly manufactured or finished goods is the lesser of: (a) Selling price less marketing expenditures in connection therewith, less (in the case of in-process goods) cost to complete; or (b) Replacement cost.

To satisfy ourselves that the prices used are correct we take a substantial number of the larger items in the inventory and check these to purchase invoices in the case of raw materials and supplies and to cost records in the case of work in process and finished goods. If the client maintains an accurate set of purchase records we check the inventory to his purchase records and then establish that the purchase records are accurately kept by testing them against the invoices themselves. We also test the cost records of the company to satisfy ourselves that the costs shown therein are reasonable. If the cost accounting system of the client ties in with the other bookkeeping records, this job is relatively easy. If this is not the case the job of verifying the cost records may be much more difficult and is a problem which should be thoroughly discussed with your senior in each particular case.

We also test the clerical accuracy of the inventory by checking the additions in detail and making a substantial test of the extensions.

An inventory certificate should always be obtained from responsible officials and employees of the company under whose direction and supervision the inventory was determined and valued. This certificate should be in the form and contain all the points covered in the example included in the office folder with which you have been provided.

Securities—The existence of securities is determined either by actual count or by confirmation from the bank or trust company with whom they are lodged. As mentioned previously, securities should be counted at the same time as cash so that it would not be possible to convert securities into cash to cover a cash shortage or vice versa. It is not always physically possible to count the securities

at the same time as the cash and if this is the case the securities should be held under your control until such time as you have an opportunity to count them. This may be accomplished by sealing the deposit box on the balance sheet date or, if the deposit box is in the vault of a trust company or bank, by obtaining a letter from them stating that the box was not opened by the client from the balance sheet date to the date of your examination. The details to be noted when counting securities are set out in your auditing procedure folder and I will not repeat them here. Bank stocks and other book stocks should be confirmed in writing from the issuing company.

In most cases securities are valued at cost. If they are temporary marketable investments they are included in the balance sheet under current assets and a notation of the market value is also made on the balance sheet. If the securities are not marketable or if they represent permanent investments in a subsidiary company, they are not included under current assets but are shown in a separate section of the balance sheet.

Fixed assets—Fixed assets consist of land, buildings, machinery, plant, equipment, etc. acquired to conduct the operations of the business. They are not held for resale but are used in the production of goods for sale and their market value from time to time is not an important factor. It is not practical as a rule to make a detailed verification of the fixed assets by physical inspection although you should always examine any substantial additions during the year.

It is the usual procedure to value fixed assets at cost less accumulated reserves for depreciation. If a proper maintenance policy is followed most fixed assets retain the same service value to a client from the date of their purchase almost until the date they are scrapped but this does not mean that we should charge their cost to expense in the period in which they finally collapse. Their usefulness is spread over their entire life and, strictly speaking, depreciation should be provided for over the same period. In practice depreciation is ordniarily provided for at the rates permitted by the income tax department as experience shows that these rates are usually quite adequate to fully provide for the cost of a fixed asset over its normal useful

life. If a client disagrees with the rates set by the income tax department and if he can obtain the approval of good engineering authorities, we are satisfied to have him use the rates recommended by the engineers and usually the tax department will also agree to these rates.

It is not usual in this country to examine the titles to properties but we should obtain a certificate from the management that the properties recorded on the company's books are held by the company free of all liens and encumbrances.

We should verify that the additions during the year are proper additions to fixed assets and are not in the nature of replacements or renewals. Similarly we should satisfy ourselves that the cost of substantial additions to fixed assets has not been included under expense accounts such as maintenance, repairs or renewals. To do this we examine vouchers for all the major additions during the year and also examine the larger charges to the expense accounts mentioned above.

We must satisfy ourselves that the rates used to provide for depreciation are reasonable and that they are applied to the proper asset values. We must also be satisfied that the accumulated reserve for depreciation is adequate.

Prepaid expenses—These consist principally of unexpired insurance and prepaid real estate taxes. The prepaid insurance is verified by checking premium receipts or original policies to the insurance register maintained by the client or if one is not kept by preparing a schedule ourselves. From this schedule the portion of the premium which has not been used may be determined. For instance, if a three year premium of $500 was paid in connection with a policy that expires eighteen months after the balance sheet date 50% or $250 will be prepaid. The total insurance premiums and taxes paid during the year must always be reconciled with the appropriate expense accounts in order to make certain that we have not missed either a prepaid item or a cancellation.

Liabilities—It is necessary to take every precaution to insure that all liabilities of a company are included in its books. One precaution is to obtain a liability certificate from the senior officials of the company stating that its records reveal all liabilities at the balance sheet date. This

certificate must always bear the signature of the president or other senior official of the company as he is often aware of liabilities which the secretary-treasurer, accountant or other employees know nothing about. A copy of the form in which we usually obtain this certificate is included in the office folder which you have.

Liabilities recorded on the books—The most important source of verification of accounts payable recorded on the books comes from statements received from creditors. The balances shown on these monthly statements should be carefully reconciled with the balances appearing in the client's books and any differences should be adjusted if necessary. Statements are not received from all suppliers but where they are not available from creditors having large balances we should insist on having the client obtain them for us. The lecture on balance sheet procedure explained in considerable detail how creditors' statements should be reconciled with the books and I will not discuss them further here. We must see as far as possible that all accrued charges have been recorded in the accounts of the company and in this connection we should pay particular attention to taxes, legal fees, workmen's compensation, salaries and wages, light, power and water bills, etc.

Liabilities not recorded on the books—In an attempt to discover any liabilities that may not have been recorded in the clients' records we should:

(1) Examine vouchers for the period subsequent to the year-end to ascertain if any of these apply to the period under audit.

(2) Examine the cheque register for the subsequent period and inquire into all large amounts paid to see if these relate to the period prior to the year-end.

(3) Compare the totals of the various expense accounts for the year with those of the previous years as any substantial reduction might indicate an undisclosed liability.

(4) Analyze interest expense account to make sure the client is not paying interest on a liability which has not been set up on the books.

(5) Examine lawyers' bills to see if legal advice has been sought in connection with lawsuits or other liabilities that might not have been disclosed to us.

(6) Compare accrued expenses with those shown in our

working papers of the previous year to see that the current year's provision appears to be reasonable. Particular attention should be paid to such items as legal and audit fees, wages and salaries, commissions, travelling expenses, bonuses, workmen's compensation, water, rent, light, telephone and interest on bank loans, bonds, mortgages, etc.

Bonds and debentures payable—We should verify the authorized amount by reference to the trust deed which also sets out the security pledged and the terms of the bonds. The number of bonds outstanding will in most cases be confirmed by certificate from the trustee and the usual form of this confirmation is shown as an exhibit in the office folder you have. If there is no trustee the number of bonds outstanding should be verified from the debenture register maintained by the client.

Capital stock—The authorized capital stock should be verified by an examination of the letters patent or supplementary letters patent. The issued capital is verified by certificate from the transfer agent if the company employs an outside concern to do this work. If the company acts as its own transfer agent the outstanding capital should be checked from the stock certificate stubs which should be in agreement with the trial balance of the share ledger.

Earned surplus—Ordinarily the only items which should appear in the surplus account in addition to the opening and closing balances for the year are the loss or gain for the year transferred from the profit and loss account and dividends paid. We should ascertain that the dividends paid and accrued during the year have been approved by minutes of the board of directors. The work to be done in verifying the correctness of individual payments to shareholders was explained to you in the lecture on cash.

Large adjustments that affect prior years' earnings should be shown separately either in surplus account, or at the foot of the current year's profit and loss account.

Verification of Profit and Loss Account

The verification of the profit and loss account is just as important as the verification of the balance sheet and the two are directly related because an overstatement of profits (and therefore surplus) ordinarily also results in an overstatement of assets or an understatement of liabilities. The most significant figures in the operating statement are:

(1) Gross profit—This is the excess of sales over cost of goods sold, and we must ascertain the reasons for any material change in both the dollar value of gross profit and the ratio of gross profit to sales. If the gross profit ratio has increased it means that selling prices have been increased, unit costs have been reduced, or that a combination of these two factors has taken place. If it is impossible to reconcile the increase or decrease in gross profit percentage with definitely established facts, it is possible that the company is fraudulently trying to inflate or deflate its profits and we will need to analyze the sales and cost of sales as set out in the office auditing procedure folder to find out what has happened.

(2) Net profit—This is the total profit after deducting all expenses. It is necessary to compare all expense accounts (including those appearing under cost of sales) with those of previous years and account for any substantial differences. The analyses of the differences in expense accounts between years will quite often disclose liabilities that have not been recorded on the books, assets which have been charged to expense, or revenue and expense items which have been improperly capitalized or deferred.

Sundry income should receive particular attention as it is very difficult to check. We should check from the source of the income to the ledger and *not* from the ledger account to the source; in this way there is less chance of our failing to verify any sources of miscellaneous income.

Working Papers

We have discussed verification of the balance sheet from the point of view of existence and valuation and your working papers should give a clear cut explanation of the verification work performed, so that the person who reviews your papers may come to a rapid decision as to the correctness of the reports and statements.

The most important purpose of working papers is to provide the senior in charge of the work with the figures and facts to prepare the financial statements and reports and to provide the partner who reviews the papers with sufficient information in such form that he will have no doubt that the proper verification procedure has been followed, that the statements are properly supported in the working papers, that the suggested comments are in order and

proper, and that no essential comments have been omitted.

Working papers are also used for other purposes such as serving as a model for the person who does the work the next year and providing information for investigations, inquiries, court testimony, and occasionally defense of professional integrity. Working papers are the connecting link between the client's records and the auditor's report and form the sole evidence of the correctness of his report or certificate.

Your papers should show fully the computation of the significant balance sheet items and relate in a clear, concise, complete and brief form the verification work performed on each item, the controversial points raised during the audit and include notes of any important conversations with the officials of the client. The papers should appear in logical order and should be properly indexed.

If you keep in mind that the partner reviewing the papers is attempting in a few hours to review the work done by you and your staff over a period of days or weeks, you will understand the necessity of having the papers drawn up in such a manner that they may be easily followed by him. Your papers should be as easy to follow as a good novel—don't prepare a jig-saw puzzle instead.

Conclusion

No one appreciates more than I do the difficulty of trying to condense fifteen years' experience into a few lectures. I also appreciate that it would be an extremely clever person who would be able to digest fully and understand in such a short time all of the material which he has received. If we had been sure that all of you would have been able to comprehend completely everything that was said in the lectures as they were delivered we would not have gone to the trouble of having them printed.

We also appreciate that due to the wide variation in experience among the different clerks attending the lectures an explanation which appears very simple and unnecessary to one person may seem quite involved and difficult to another. We know that these lectures are not all inclusive but feel that they contain a wealth of practical auditing information and if you will read and re-read them until you understand them completely, we will have accomplished

what we set out to do. As you re-read the lectures there may be points which are not clear and you should discuss these with the seniors in the office, who will be very happy to explain them to you.

GLIMPSES OF CURRENT ACCOUNTING LITERATURE

A Summary Prepared by John Douglas Campbell,
Chartered Accountant

BULLETINS

Cost Accounting

Volume XXIV, No. 11, 1st February 1943 and No. 12 of 15th February 1943 issued by the National Association of Cost Accountants (385 Madison Avenue, New York) discuss practical means of alleviating indirectly and directly the stress which has been placed on accounting departments as a result of wartime shortages and increased production.

Office Forms—William C. Hunn in an article "Types of Office Forms and Their Design" discusses the part which office forms play in the effectiveness of the clerical workers' operations and sets out a practical basis for measuring the effectiveness of the forms in actual use in any business organization.

"Since printed forms so vitally affect the efficiency or inefficiency of the work of all of the personnel in an organization, they must be designed with clerical economy as one of the prime considerations." Special attention is devoted to an outline of the continuous forms to be found in actual use with stress on the savings to be accomplished through the combination or the writing at one time of related records.

Punched-Card System—Frank A. MacCauley in "Punched-Card System of Payroll and Labor Cost Accounting" outlines ways and means for the extensive and efficient use under present-day conditions of punched-card equipment.

A complete outline of the mechanical procedure followed in the preparation of the payroll through the use of the punched-card system is presented illustrated by actual exhibits and charts.

Accounting

Government Contracts—Cost Plus Fixed Fee—Accounting Research Bulletin No. 19 issued in December 1942 by

the Committee on Accounting Procedure of the American Institute of Accountants "Accounting Under Cost Plus Fixed Fee Contracts" and published in the February 1943 issue of *The Journal of Accountancy* (13 East 41st Street, New York, N.Y.) presents an opinion on the four major problems which have arisen out of C.P.F.F. contracts (cost-plus-fixed-fee) namely;

(1) When should fees under such contracts be reflected in the contractor's income statement?
(2) What amounts are to be included in sales or revenue accounts?
(3) What is the proper balance-sheet classification of unbilled costs and fees?
(4) What is the proper balance-sheet treatment of various items debit and credit identified with C.P.F.F. contracts?

The major portion of the bulletin covers a discussion of the first problem. The opinion offered is as follows: "Fees under C.P.F.F. contracts may be credited to income on the basis of such measurement of partial performance as will reflect reasonably assured realization. One generally acceptable basis is delivery of completed articles. The fees may also be accrued as they are billable, under the terms of the agreement unless such accrual is not reasonably related to the proportionate performance of the aggregate work or services to be performed by the contractor from inception to completion."

Auditing

Wartime Financial Statements—Statement No. 15 on Auditing Procedure issued in December 1942 by the Committee on Auditing Procedure of the American Institute of Accountants and published in the February 1943 issue of *The Journal of Accountancy* covers the question "Disclosure of the Effect of Wartime Uncertainties on Financial Statements".

Against a general outline of the more significant uncertainties engendered by the present war the problem of disclosure is raised. The general discussion is segregated as between the disclosure of such uncertainties in the financial statements and in the auditor's report.

In referring to disclosure in the financial statements it is pointed out that "despite all uncertainties . . . . financial

statements are essential". The different methods of disclosure are outlined which range from footnotes (specific and general) to the use of special reserves. In referring to the disclosure in the auditor's report no specific form is proposed as "each independent public accountant will . . . . prepare his report to meet the circumstances peculiar to the particular case". The cases range from an unqualified report to a report in respect to which the auditor is unable to present even a qualified opinion.

Inventories—Statement on Auditing Procedure No. 16, "Case Studies on Inventories" covers the committee's views as to the procedures to be adopted by the independent auditor in satisfying himself as to inventory quantities as required in "Extensions of Auditing Procedure" issued by the American Institute of Accountants, particularly where external measurement or survey may be inadequate.

The cases presented cover mainly chain and departmental stores.

Statement on Auditing Procedure No. 17 issued in December 1942 and published in the February 1943 issue of *The Journal of Accountancy* also considers the question of inventories—"Physical Inventories in Wartime".

As companies have been forced either voluntarily or otherwise to omit the taking of their physical inventories the questions have arisen—"(1) what additional or alternative auditing procedures can and should be undertaken to remedy the omission, and (2) the effect on the independent accountant's short form of report".

The discussion presented does not seek to present categorical conclusions but rather sets out suggestions "of alternative auditing procedures and assumed circumstances which will influence any decision".

In discussing alternative procedures it is pointed out that where physical inspection cannot be made either totally or in part the only remaining procedures will be confined to the accounting records and statistical data. The different circumstances likely to be encountered are outlined followed by discussions of procedures which will in part supplant physical inspection.

In covering the question of the reflection of this situation on the auditor's report it is pointed out that the degree of qualification will be determined by the extent to which

alternative procedures are considered as adequate replacements for the actual checking of the physical inventories. Where merely an over-all estimate has to be used in most cases it "would be too unreliable to provide a basis for an informed opinion as to the financial statements as a whole."

Government Receivables—Statement on Auditing Procedure No. 18, "Confirmation of Receivables from the Government" issued in January 1943 and published in the February 1943 issue of *The Journal of Accountancy* covers the question of the required confirmation of receivables under conditions where persons or agencies refuse to confirm accounts in order to conform to the audit requirements as set out under the "Extensions of Auditing Procedure".

"In such cases his disclosure of inability to secure confirmation of government receivables by communication with the debtor may well be accomplished by a statement that he has satisfied himself by other means." Where other means are not in existence the auditor must determine whether the situation warrants merely a qualified opinion or contains grounds for not expressing an informed opinion regarding the financial statements as a whole.

ARTICLES

(1) Report Writing

James W. Rountree in an article "Suggestions for Writing Better Comments" published in the February 1943 issue of *The Journal of Accountancy* stresses the significance of well-written reports to both the accountant and the layman outlining various suggestions as to ways and means of improvement.

In analyzing report writing in general it is pointed out that the major fault lies in the failure by many accountants to give sufficient time and thought to the problem of its preparation. In considering the question of the time of preparation of comments it is suggested "I see no reason why it would not be desirable to record on each analysis or work sheet containing commentarial information a related working outline to be used as a framework for the comments".

The general principles of clarity and conciseness of expression and the creation of reader interest are each considered supplemented by suggestions in each case as to how their attainment may be brought about.

In closing Mr. Rountree leaves the thought "Time and effort expended by the accountant in improving his ability to write reports should be a noteworthy contribution to the general advancement of the accounting profession".

(2) Auditing—C.P.F.F. Contracts

Victor Z. Brink in an article "Auditing Problems Relating to Cost-Plus-A-Fixed-Fee Contracts" published in the February 1943 issue of *The New York Certified Public Accountant* (15 East 41st Street, New York City) discusses recent advances made in the field of auditing of government contracts pointing out clearly the part which is being played by internal check and in particular by the internal auditor.

In outlining the auditing procedures of the War Department (U.S.) the change in policy from a detailed audit to a test audit supplemented by a degree of reliance on the system of internal check in actual operation is brought out clearly. "Large field staffs are being reduced and many persons are being made available for other war activities. In all cases the more experienced people are being retained and it is believed that a more effective audit is actually being obtained which goes even farther than formerly in protecting the interests of the Government."

The decentralization of the government general accounting office field audit is discussed. Special mention is made of the advantages of speeding up final settlement which have arisen out of the procedures.

(3) Inventories

The February 1943 issue of *The Controller* (1 East 42nd Street, New York City) carries two articles bearing on the questions arising in the taking and evaluating of inventories.

W. J. Jacquette in "Three Major Problems Involved in Taking and Evaluating Inventories" discusses the questions of (1) maintenance of records for the purpose of proper inventory control, (2) methods of verification of inventories at different locations both by the company and the company's auditor, and (3) under what method and at what value shall the inventories be stated?

In discussing the question of inventory pricing special reference is made supported by statistical data as to the wide variance existing between companies in respect to the interpretation placed on the inventory basis of valuation

used. The various interpretations placed on the term "cost" are considered. Special reference is made to the last-in first-out basis namely as a basis designed to keep "unrealized profits in inventory from being taxed".

George E. Frazer in "Accounting Problems in Inventory Taking and Evaluating" outlines the significance of the inventory question as an accounting problem with special reference to the "last-in first-out basis of inventory valuation."

The recent suggestions of the American Institute of Accountants in "Extensions of Auditing Procedure" as to physical examination of inventories by the independent auditor is discussed and the opinion is expressed that "the function of the trained accountant is to prove the inventory by accounting tests as to turn-over and mark-up, not to waste aimless time in aimless strolling about on factory floors watching mechanical counts . . . The valuation of inventories is best tested where the physical count and the average cost prices used are compared class by class and on important items item by item with historical turnovers and mark-ups".

TABLE OF EXCHANGE RATES

(Kindly supplied by The Canadian Bank of Commerce, Toronto)

	27th February 1943	*15th March 1943*
U.S. Dollars	10-11% P.	10-11% P.
Sterling	443-447	443-447
Australian Pounds	358½	358½
New Zealand Pounds	360	360
South African Pounds	443	443
British West Indies—Dollars	9270	9270
India—Rupees	3356	3356
Hong Kong—Dollars (Custodian rate)	2781	2781
Straits Settlements—Dollars (Custodian rate)	5226	5226
Sweden—Kronor	2635	2635
Switzerland—Francs	2569	2569

Note: The above currencies are expressed as follows: Pound currencies—Canadian cents per unit; Continental currencies and sundry British Empire—Canadian cents per 100 units.

JOINT LABOUR-MANAGEMENT COMMITTEES

By Eileen Mitchell, B.A., Toronto

WITHIN the last year there has been a new development in industrial relations in wartime industries which illustrates the old principle that "necessity is the mother of invention"—this is the growth of labour-management joint production boards. America's industrialists were faced in 1940-41 with the greatest problem ever before them—a united nation demanding peak production, and on the other hand, striking local unions and bitter labour controversies. The two made strange bedfellows. Every picket wanted to win the war and yet he wanted certain rights and privileges recognized and had found the moment when his demands would be heeded. Thus he was torn between the two diametrically opposed wishes. There were two alternatives to the problem—government intervention, or chaos as each group shut the door on the other. As always in time of crisis there are big men who can rise to meet the moment of crisis and somehow find a solution. In this instance the solution was a compromise. Needless to say the problem is not yet over, but the urgency of it has passed and most of us find that we have pushed it to the back of our minds. The joint boards for dealing with plant problems go a long way in resolving the difficulty but before the new development can be seen in its true light we should recast the history of the problem.

A Background of Friction

It is a fact, particularly in the United States but also in Canada, that in 1940 and 1941 there was no firm with over a hundred employees which did not have a labour problem. Either there was a union and there were contract negotiations, or there was no union and the employees were being organized or were marked down for future attention by a union, or there was a struggle between conflicting unions.

When Franklin D. Roosevelt went into power in the United States, to him and to his administration the encouragement of unions became the policy of government. Long standing rivalries which had died down during the depression period came to the fore again. Unionism became a great political force and industrialists more and more frequently were stopped in their course of expansion

to consider demands of their employees. The membership in unions in the United States grew from between one and two million to well over ten million in the course of ten years. The reason assigned to the growth in membership by investigators is that the average worker wanted to join the union in the belief that by concerted action with his fellow workers he would benefit himself and his family. He did not join to retard his employer nor to prevent the advancement of his company, but merely to make for himself a more secure world in which would be greater opportunities. Many workers were coerced into joining, others joined because they wanted to get into the swim, but statistics show that the majority joined because they wished to do so.

Unions are Firmly Established

Thus we have and must accept as a fact the union as the bargaining power for labour. The union organizations have become businesses. The union is not to be thought of in terms of opposition to management; that is not the wish of the union. It does retard free enterprise and it does abrogate the previously inalienable right of the owner to make decisions in connection with defined spheres of plant activity, but it is directed towards expansion for the good of all.

The individual unions had much internal strife; agitators bent on turning the trend toward a more revolutionary end, overly radical leaders, corrupt leaders, all lent their hands to deflecting the unions from their true course. However, gradually the unions have gained more and more independence. Thus we have a situation which runs the gamut, from those who are ardent workers anxious only to benefit themselves and their kind in co-operation with management, to those for whom the particular union is the be-all and end-all.

War Emphasized Problem

In the first years of the war as plans were being made to gear industry to a war basis, we saw the discrepancy appear. Everywhere on the continent industrialists were looking for a solution that would allow them to impose longer working hours and to employ non-union workers, and everywhere labour leaders were anxious for the rights they had worked so long to obtain. A solution that was

found in many instances was the adoption of joint boards to deal with plant problems. In Canada and in the United States they are being suggested as the only immediately possible solution. Donald Nelson, the dynamic head of the United States War Production Board, and Canada's own authorities, are pushing a huge war production drive. They want to increase efficiency, they want to get the whole plant operating for one purpose—production for war; they want to scrap obsolete or unnecessary practices and routines, they want to conserve materials, they want, above all, to avoid friction. Their suggestion?—joint labour-management production committees.

Originally Britain tried the method but it had not gained wide acceptance in America because both management and labour were afraid to trust their problems to a joint board. The few experiments showed the surprising effectiveness of such organizations.

Two Types of Committee

There are two types of committee. One is a plant council which can deal with problems affecting the welfare of the workers and can advise on such matters as hours of work, wages, overtime and general plant conditions. The other is a joint production board. Here the production problems of the entire plant are discussed. Such labour-management plant committees, dealing with production, efficiency, salvage and kindred problems will surely survive the war. Not perhaps on as wide a scale as that on which they have been established in plants on war production and as encouraged and sponsored in the United States by the War Production Board; but in situations where they have obviously worked well they will not be abandoned. They were on their way and the war accelerated their adoption. More and more problems which formerly were the province of management are being made the concern and problem of the committee.

Production charts, suggestion boxes, slogan contests, and plant drives are all suggested. The committee works together to devise the means and enforce the ways to forward such plans and schemes.

In Canada most of the war plants have introduced such schemes—Massey-Harris, John Inglis, Research Enterprises and many others. Leaders of industry join with union

leaders and government leaders to say that this mode alone will answer the problem of production requirements. Better than more men, better than more machines, better than more plants is the efficiency of the men we have, the effectiveness of the machines we have, and the productivity of the plants we have. What matters is that all are at their peak efficiency, every sinew of the plant body stretched to the last effort for productivity—for Victory.

RULING ON EMPLOYERS' T.4 RETURNS

The following regulation on Employers' T.4 returns was passed by the Treasury Board and approved by Order in Council on 9th December 1942:

THE BOARD recommend that under the authority of the *War Measures Act*, the following regulations respecting the filing of statements in connection with salary and wage deductions under the *Income War Tax Act* be established:

Regulations

1. Any employer who ceases to be an employer must file a statement on the prescribed form as provided for under Section 39 of the *Income War Tax Act*, and known as Form T.4 Remuneration Summary, with attached Form T.4 Supplementary, on or before the expiration of one week from the cessation of salary or wage payments from which deductions have been made or should have been made.

2. When a business or activity which has been an employer has ceased to be an employer, and the statement on the prescribed form required by these Regulations has not been filed within the time prescribed, the proprietor, part-owner, associate, member, trustee, secretary, treasurer or officer of any such business or activity shall be liable upon summary conviction to a penalty of not less than $100.00 or not more than $1,000.00, and, in default of payment, to imprisonment for a period not exceeding six months.

ONTARIO INSTITUTE'S SIXTIETH ANNIVERSARY

Address of President F. C. Hurst at Annual Dinner of The Institute of Chartered Accountants of Ontario, at the Royal York Hotel, Toronto, 5th March 1943

YOUR Honour, Colonel Gibson, honoured guests, ladies and gentlemen, in welcoming you to our annual mid-winter dinner this year, I am also welcoming you to the sixtieth anniversary of the incorporation of The Institute of Chartered Accountants of Ontario. When our charter was first sought, there already existed an association known as the "Institute of Accountants and Adjustors in Canada". This Institute had been formed on the 10th December 1879, after a meeting had been held to which "all public accountants, accountants in banks, monetary institutions and insurance companies, representative bookkeepers and others in Toronto" had been invited. At 31st December 1880 there was a total membership in this Institute of fifty-nine. During 1881 efforts were made to affiliate with the Institutes of Accountants in Great Britain, but the charter of the English Institute prevented such affiliation, even as it does today.

The first application for a charter was made in 1881, but this was not granted until 1st February 1883; the petition at that time was supported by over two hundred names of citizens from a number of cities and towns in Ontario. In our earliest year book mention is made of the difficulty in obtaining our charter and it states that "Council held the view that the comparatively slow progress made towards obtaining recognition from the public of the claims of accountancy to be considered as a profession has been due in no small measure to the superficial character of the education deemed necessary to fit a man for intelligently undertaking the duties of an accountant or even a bookkeeper".

The charter members were the president and council of the Institute of Ontario, as it was then called. There were eighteen charter members and our first president, Mr. Samuel Bickerton Harman, was also mayor of Toronto at the same time. It was in the council chamber at the city hall that he delivered his inaugural speech as the first president of the Institute.

At the first annual meeting of the Institute held on 7th March 1884, the president's report showed a membership of one hundred and seventy-five. The balance sheet showed $411 cash on hand and in bank, with $264 annual dues outstanding, which were by no means considered "bad" debts!

As early as 1885 examination facilities were set up and even the charter members wrote and passed the examinations in order to obtain a diploma entitling them to use the designation "Chartered Accountant".

In 1894 the first lady student wrote the examinations, but was unsuccessful. The following year three more applied, and after much discussion council followed the lead of other "intellectual" societies and barred women from the ranks of Chartered Accountant students. It took 36 years for Council to see the light of day and lift this ban, as it was not until 1930 that Mrs. Helen Burpee was admitted to membership and became the first woman Chartered Accountant in Ontario. Today we have twenty-seven women registered as students-in-accounts; three of them passed the primary examination in 1942 and two the intermediate.

It was in 1922 that the Institute compiled its own instruction course; and it has been administered by Queen's University ever since. Before that time, students studied at business colleges and applied to the Institute at such time as they felt prepared to write the Institute examinations. In the first instruction course there was only three years' work; later this was extended to four, and in 1935 a fifth year course was added, so that each year of the students' apprenticeship now has its attendant course of instruction. To begin with there were only two professional examinations—the intermediate and final, as the primary examination was a test of a student's general knowledge and included such subjects as reading, penmanship, spelling, arithmetic, composition, etc. However, now we require our students to have a standing of honour matriculation at least before they can register as students-in-accounts, and in 1943 our primary examination will be based entirely on the professional subjects of accounting, auditing and law.

So much for our development as an Institute—during these years we have also developed in public service. It is recognized that both training and study are required to

fit one for the responsibilities of a qualified accountant. Today few businesses can operate without our assistance, and we are able through our work in government, industry and public practice to feel the financial pulse of our country. We have, in later years particularly, been approached for suggestions regarding Dominion legislation and our suggestions in some instances have been accepted. Industry has required the services of a number of our men as accountants, controllers, managers and financial experts. The war with all its attendant government regulations and problems of economy has imposed upon us even greater responsibilities. The Government employs nearly one hundred and fifty of our members in various departments, such as the Income Tax, Treasury, Wartime Prices and Trade Board, Munitions and Supply, and Foreign Exchange Control Board, including those in permanent and wartime positions as well as those on loan. Another one hundred and twenty-five members are on active service in His Majesty's forces and four have paid the supreme sacrifice. We also have over two hundred students-in-accounts in the services, of whom four also have paid the supreme sacrifice. The professional accountant is making his contribution by continuing his services to shareholders and management in the practice of auditing and in the application of sound accounting principles to the many new problems imposed by government regulations.

Now what of the future? We cannot be satisfied with the past. What must our contribution to Canada be in the next sixty years? I believe that the government will require our services as much after the was as during it. Bureaucracy will not entirely cease with hostilities and with any national social plan chartered accountants will be needed to help design and administer it. I believe more and more we shall be expected to take administrative responsibility for the government and we, as a profession, must be ready to make constructive and even concrete proposals for the regulation of industrial and financial control.

Industry, too, will absorb many more qualified men—for it must find a road between monopoly and unregulated competition. Plans must be formed to make industry a pioneer in the new world, where national service replaces selfishness; for the primary purpose of industry can no longer be the making of the greatest possible profit, but

to render the greatest possible service to the community. In order for this to happen, chartered accountants must become the conscience of industry; and the purpose of our professional work must be to enable management to discharge its twin responsibilities of maintaining steady employment for its workmen and of supplying the wants of society, instead of simply ascertaining the amounts of profits available for distribution. We will need men of vision who will think creatively about the country's finance, not only in terms of responsibility to shareholders, but in terms of responsibility to the whole country. Canada's huge resources must be mobilized for peace, just as they have been for the war. It must be our responsibility as a profession to aid men in industry and finance to see how this can be done—so that the goods of this country are made available for all and for the exploitation of none.

"RELATIONSHIP" DEFINED

The following regulation concerning relationship for purposes of the *Income War Tax Act* was recently adopted by the Department of National Revenue:

WHEREAS the First Schedule to the *Income War Tax Act* provides for the taxation, in the same manner as a married person, of an unmarried person who maintains a self-contained domestic establishment and actually supports therein a person wholly dependent upon the taxpayer and "connected with him by blood relationship, marriage or adoption;"

AND WHEREAS under Section 75, subsection 2, of the *Income War Tax Act*, regulations may be made for carrying this Act into effect;

NOW THEREFORE for the purposes of the said First Schedule, it is hereby declared that:—

(a) "blood relationship" will be regarded as extending to the taxpayer's parents, grandparents, great grandparents, children, grandchildren, great granchildren, brothers, sisters, uncles, aunts, nephews and nieces but no further;

(b) "marriage" will be regarded as extending to the parents, grandparents, great grandparents, brothers and sisters of the taxpayer's spouse, and the taxpayer's stepchildren, but no further;

(c) "adoption" only extends to children legally adopted.

PROVINCIAL NEWS

ALBERTA

The Council of the Institute of Chartered Accountants of Alberta has appointed Mr. M. C. McCannel, F.C.A., to the office of secretary-treasurer of that Institute. He replaces Mr. James A. Henderson who recently resigned from the post.

ONTARIO

The annual mid-winter dinner and reception to new members, which this year marked the sixtieth anniversary of the Ontario Institute, was held at the Royal York Hotel, Toronto, on Friday, 5th March 1943. Three hundred members, students and guests heard Colonel the Honourable Colin W. G. Gibson, K.C., Minister of National Revenue, speak on "Taxation and the Accountant". Mr. J. F. Gibson, F.C.A., introduced the speaker and Mr. E. Jay Howson moved the vote of thanks.

The toast to "our guests" was proposed by Mr. George S. Jewell, secretary-treasurer, and responded to by Mr. L. F. Winchell, president of the Toronto Board of Trade. Among the distinguished guests at the head table were His Honour the Lieutenant-Governor; The Honourable Mr. R. S. Robertson, Chief Justice of the Supreme Court of Ontario; Captain Eustace Brock, Officer Commanding, Reserve Divisions, R. C. N. V. R.; Brigadier-General G. E. McCuaig, C.M.G., D.S.O., V.D., Temporary District Officer Commanding M.D. No. 2; Squadron Leader Harvey L. Good, representing the R. C. A. F.; Mr. L. F. Winchell, President, Toronto Board of Trade; Mr. C. Fraser Elliott, K.C., Commissioner of Income Tax, Ottawa; Mr. T. A. Richardson, President, Toronto Stock Exchange; Mr. D. L. McCarthy, K.C., Treasurer, The Law Society of Upper Canada; Mr. Alfred Smibert, President, The Society of Chartered Accountants of the Province of Quebec; Mr. J. A. McNeill, General Manager, The Canadian Press; Professor R. G. H. Smails, C.A., representing Queen's University; Mr. Kenneth W. Dalglish, C.A., of the Board of Referees, Excess Profits Tax Act; Mr. Hugh D. Paterson, Inspector of Income Tax of the Toronto District. The Dominion Association of Chartered Accountants was represented by Mr. M.

C. McCannel, Edmonton, past President and Mr. Kris A. Mapp, Toronto, President.

Mr. Russel R. Grant, F.C.A., First Vice-President, presented the various prizes awarded by the Institute in the recent examinations. 2/Lt. R. W. Meanwell of Windsor, who won the gold medal for the highest standing in Canada in the accounting and auditing papers, as well as the Institute gold medal, was given the Dominion medal by Mr. Kris A. Mapp, President, the Dominion Association.

The welcoming speech of Mr. F. C. Hurst, President, appears elsewhere in this issue.

LEGAL DECISIONS

On 2nd February 1943 the Supreme Court of Canada upheld the judgment of the Exchequer Court of Canada in *The Minister of National Revenue* v. *The Kellogg Company of Canada, Limited.* Counsel for the appellant rested his case on the decision of the Supreme Court of Canada in *The Minister of National Revenue* v. *The Dominion Natural Gas Company, Limited* (1941). See L 51. The Exchequer Court of Canada's judgment in the *Kellogg* case was reviewed in detail in The Canadian Chartered Accountant of May 1942 and is also reported in our Legal Decisions service (no. L 59). In concluding his judgment for the Supreme Court of Canada, Chief Justice Sir Lyman Duff said: "It is very clear that the appellant does not succeed in bringing his case within the decision upon which he relies. The appeal should be dismissed with costs."

Income Tax on per diem Allowance

(Maurice Samson v. *Minister of National Revenue)*

Exchequer Court of Canada

The appellant in this case, a chartered accountant resident in the city of Quebec, was appointed hides and leather administrator of the Wartime Prices and Trade Board, by order-in-council dated 3rd October 1939. The order-in-council included the following clause regarding payment to him: "That the recommendation of the Wartime Prices and Trade Board that the said Maurice Samson shall receive a salary of one dollar per annum and his actual transportation ex-

penses and a living allowance of twenty dollars per diem while absent from his place of residence in connection with the duties aforesaid, be approved."

The appeal was against assessment by the Income Tax Department of the per diem allowance. The judgment of the Exchequer Court of Canada, rendered by Hon. J. T. Thorson 27th February 1943, is in favour of the appellant, and concludes as follows:

"As I interpret the order-in-council, I have come to the conclusion, having regard to all the circumstances of the case, that the per diem living allowances authorized by it involved no element of remuneration or net gain or profit or gratuity to the appellant, and did not result in any gain or profit to him. They were paid and received only as reimbursement of living expenses, over and above ordinary personal and living expenses up to the fixed amount per day. They were not in any sense 'income' as defined by the *Income War Tax Act* and the appellant should not have been assessed for income tax purposes in respect of them.

"In view of what has already been stated it is, perhaps, not necessary to say that the use of the word 'allowance,' whether in a statute or otherwise, does not of itself determine whether the amount of it is solely reimbursement of expense or whether it may have implications of remuneration. It is clear that in many cases the provision of an allowance, having regard to all the attendant circumstances, is in reality the payment of remuneration in respect of which the recipient is properly assessable for income tax purposes. The test is not merely that the amount is fixed. No such easy determination is possible, however convenient it may be for administrative purpose. In each case the true nature of the amount, by whatever name it may be described, must be determined.

"In view of the foregoing the appeal herein must be allowed with costs."

OBITUARIES

The Late Robert James Dilworth

The Institute of Chartered Accountants of Ontario regrets to announce the death of Robert James Dilworth, a distinguished member of the profession, at Toronto on 18th March 1943 at the age of seventy-four.

Mr. Dilworth qualified as a chartered accountant in 1903 and from 1913 until the time of his death was a senior partner in the firm now known as Clarkson, Gordon, Dilworth & Nash. He served as President of the Ontario Institute in 1919-1920 and 1920-1921 and contributed to this magazine on many occasions. He had many interests and a host of friends in a wide variety of fields. He believed that relaxation and amusement have their place in the scheme of things and succeeded in getting his full measure of fun out of a complete and well rounded life.

Mr. Dilworth was a master of the English language despite the fact that his formal education ended at thirteen. He never tired of learning and it can truly be said of him that his real education continued without interruption throughout his life. He learned to speak excellent French after he was fifty and acquired a working knowledge of both Italian and Spanish while in his sixties. He was a modest man who shunned ostentation and display. His kindly, tolerant disposition and keen sense of humour were a delight as well as an inspiration to all his friends and associates who will sadly miss him.

The Institute extends sincere sympathy to his widow, his two daughters, his two sons, his partners and to his many friends.

The Late Sergeant John Marne Storey

The Institute of Chartered Accountants of Ontario announces with deep regret the death, by accident in battle manoeuvres, of Sergeant John Marne Storey, on 4th March, at Sarcee Military Camp, Alberta.

Sergeant Storey was a graduate of the University of Toronto and joined the staff of McDonald, Currie & Company in 1937. He passed the final examination and was admitted to membership 23rd July 1941. A year later he enlisted in the Brockville Rifles, and would have, within a few days of his death, completed his course of training.

To his wife and parents the Institute extends sincere sympathy.

STUDENTS' DEPARTMENT

R. G. H. SMAILS, C.A., Editor

NOTES AND COMMENT

After consultation with the principal organizations able to offer advice on the matter the Committee of the London Stock Exchange has issued a formal appeal to company directors urging them to practice clarity and fairness in proposals submitted to shareholders. In wartime even fewer shareholders than usual find it possible to attend company meetings and so it is urged that when any business other than pure routine is to be dealt with at a meeting directors should "take steps to ensure that every shareholder shall be in a position to form a fair opinion on the merits of the proposals and may have an effective voice in the decision to be made". The Committee requests (1) that circulars and statements sent to shareholders should be unambiguous and couched in clear and simple language; (2) that fourteen days' notice of meetings should be given even where the statutory minimum is seven days; and (3) that stamped proxy forms should be sent out on which shareholders can easily vote either for or against the resolution in question. The Committee regards these three points as so essential that they are to be incorporated in the listing requirements in the near future.

In this country, at least so far as companies incorporated under the Dominion Companies Act are concerned and the matter in question is an arrangement or compromise coming within Section 122 of that Act, the supply to shareholders of adequate information would seem to be most satisfactorily assured by the express provisions of the act and by the manner in which the courts have construed their responsibilities under the section cited. Our Parliament can take credit for having regulated in a most sensible and effective manner an important aspect of corporation procedure which, apparently, is still left in England to the imperfect regulating powers of a private organization. This further confirms us in our belief that the Dominion Companies Act of 1934, imperfect as it may still be in some respects, is one of the best if not the best

piece of company legislation in existence in any of the British countries.

* * *

Examiners, when they turn their minds to partnership accounting, seem to have a particular affection for problems involving the introduction of a partner into an existing business. They usually require the student to record the admission of the new man by adapting the books of the existing business to the needs of the partnership. This is a trifle unfair because the books of one business organization cannot really become the books of another business organization, and because it blinds the student to the fact that his task is really that of recording the inception of a partnership business by debiting the books of the firm with the assets brought in by the several members and crediting the capital account of each member with the amount of assets which he has contributed.

Examiners also, on occasion, tend to regard as alternate arrangements the two entirely different plans for admission of a partner into an existing business, viz., the plan whereby the newcomer is offered a share of the existing business at a specified price and the plan whereby the newcomer is admitted as a partner on condition that he contributes a specified amount of money to the partnership. The former plan is a device whereby the owner of an existing business which has no need for additional capital can reduce his investment in that business; the second is a device for securing additional capital in a business which is expanding and whose capital needs cannot be satisfied by the existing owner.

* * *

PROBLEMS AND SOLUTIONS

THE PROVINCIAL INSTITUTES OF CHARTERED ACCOUNTANTS

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM I

INTERMEDIATE EXAMINATION, DECEMBER, 1942

Accounting II, Question 1 (30 marks)

The following statements of operations of the Sunset Manufacturing Company, Limited, for the year ended 31st December 1941 have been prepared by the bookkeeper of the company:

EXHIBIT A

Statement of Profits

Sale—3,500 articles at $40	$140,000
Deduct—cost of 3,500 articles at $30, per Exhibit B	105,000
Net profit for the year	$ 35,000

EXHIBIT B

Statement of Cost of Manufacture and Cost of Sales

Total expense, per Exhibit C		$140,000
Articles produced	4,500	
Articles in process	500	
Total	5,000	
Cost per article	$ 28	
Inventory of 1,000 articles at $28	$28,000	
Inventory of 500 articles in process at $14	7,000	
		35,000
Cost of sales—3,500 articles at $30		$105,000

EXHIBIT C

Expenses

Raw material purchases	$40,000	
Add inventory at 1st January, cost plus freight	1,500	
	$41,500	
Deduct inventory at 31st December, cost plus freight	3,000	
		$ 38,500
Advertising		4,595
Freight		4,600
General expense		10,505
Interest		1,800
Fire insurance		2,300
Power, light and heat—factory		7,100
Printing and stationery		2,200
Rent of office		2,400
Repairs—building		300
Repairs—machinery		2,500
Salaries and wages		58,000
Sundry expense—factory		3,000
Supplies—factory		900
Taxes—factory		1,300
		$140,000

The accuracy of the statements is questioned and you are requested to check them.

On investigation, you obtain the following additional information relative to the accounts as at 31st December 1941:

Salaries and wages:

Administrative	$ 14,000
Office	3,400
Salesmen's salaries and commissions	16,400
Labour—direct	16,500
Labour—indirect	7,700
	$ 58,000

Freight:

On purchases	$ 2,800
On sales	1,800
	$ 4,600

The following items have not been taken into account:

Accrued wages:	
Labour—direct	$ 1,930
Labour—indirect	725
Fire insurance premiums unexpired	500
(two-thirds of insurance expense is applicable to factory building and machinery)	
Printing and stationery on hand	850
Interest prepaid	200
General expenses prepaid	1,300
Provision for doubtful accounts receivable	2,100
Provision for depreciation:	
Building—4% on $52,000	
Machinery—10% on $16,000	

The articles in process require no further raw material and otherwise are half completed.

Required:

(a) Profit and loss statement for the year 1941
(b) Manufacturing statement for the year 1941
(c) Working papers showing computation of work in process and finished goods inventories at 31st December 1941.

SOLUTION

THE SUNSET MANUFACTURING COMPANY LIMITED

PROFIT AND LOSS STATEMENT
for the year ended 31st December 1941.

Sales			$140,000
Cost of sales			63,420
Gross profit			$ 76,580
Selling expenses			
Salesmen's salaries and commissions		$16,400	
Freight		1,800	
Advertising		4,595	
		$22,795	
General and administrative expenses			
Administrative salaries	$14,000		
Office salaries	3,400		
Printing and stationery	1,350		
Rent of office	2,400		
Fire insurance on stock	600		

General expenses	9,205		
Interest	1,600		
Bad debts	2,100	34,655	57,450
Net profit for the year			$ 19,130

THE SUNSET MANUFACTURING COMPANY LIMITED

Manufacturing Statement
For the Year Ended 31st December 1941

Raw material		
Inventory 1st January		$ 1,500
Purchases		40,000
Freight on purchases		2,800
		$ 44,300
Inventory 31st December		3,000
		$ 41,300
Direct labor		18,430
Manufacturing expense		
Indirect labor	$ 8,425	
Power, light and heat	7,100	
Supplies	900	
Sundry expenses	3,000	
Repairs—factory	300	
Repairs—machinery	2,500	
Fire insurance, factory and machinery	1,200	
Taxes	1,300	
Depreciation—factory	2,080	
Depreciation—machinery	1,600	28,405
		$ 88,135
Deduct: Inventory of work in process at 31st December		6,595
Cost of finished goods manufactured		$ 81,540

Statement of Cost of Sales

Cost of finished goods manufactured	$ 81,540
Deduct: Inventory of finished goods at 31st December	18,120
Cost of goods sold	$ 63,420

Computation of inventories of work in process and finished goods as at 31st December 1941

Work in process

Raw material				
Cost per unit	$\frac{\$41,300}{5,000}$	=	$8.26	
Units in process and value			500	$ 4,130
Direct labor				
Cost per unit	$\frac{\$18,430}{4,750}$	=	$3.88	
Units in process and value			250	970

Manufacturing expense				
Cost per unit	$\frac{\$28,405}{4,750}$	=	$5.98	
Units in process and value			250	1,495
				$ 6,595
Finished Goods				
Cost per unit	$\frac{\$81,540}{4,500}$	=	$18.12	
Units on hand and value			1,000	$18,120

PROBLEM II

FINAL EXAMINATION, DECEMBER, 1942

Accounting II, Question 4 (25 marks)

You have been requested to organize and instruct the executive staff of a large manufacturing concern on how to install a system of budgetary control.

Certain directors are entirely unfamiliar with the reason for setting up such a system and are not completely in favour of the proposed installation. They feel that it is only another way of increasing expenses.

Required:

(a) Submit your notes and plan in connection with the setting up of the system of budgetary control.

(b) Draft a letter to the directors as to the purpose and uses of budgets, etc., giving any explanations you consider necessary.

SOLUTION

10 Marks out of 25 marks

(a) The following is a sketch of some of the points which could be covered.

(1) (i) Short history of company and personnel.
(ii) Short history of accounting policies and system over previous few years.

(2) Divisions of proposed budget:

Sales budget Production budget Expenses { Variable budget / Non-variable budget Cash budget	Projected profit and loss account Projected balance sheet

(3) Obtain past financial statements.
These will be useful to check for omissions and apparent reasonableness of primary or final budgets presented.

(4) Have all budgets signed to attach responsibility for reasonable accuracy and care in preparation.

(5) Prepare instructions for setting up primary budgets.
Prepare instructions for reconciliation of primary budgets between departments.
Prepare instructions for setting up master budget.
Prepare instructions for reconciling budget and actual figures and specify when these reconciliations are to take place.

(6) Prepare program of information to be furnished to officials and specify time of delivery.

(7) Notes on matters taken into consideration in setting the time period various budgets are to cover.

(8) Forms of reports and charts, etc.

15 Marks out of 25 marks

(b) Draft of letter should cover:

(1) Introduction and purpose of letter.

(2) Explanation of what a system of budgetary control is.

(3) Basis upon which a budget is set—probable, not possible attainments.

(4) Advantages of a system of budgetary control.

(i) Planning and charting of business course,
(a) to make profit,
(b) to keep all parts of business ready to follow trends of industry.

(ii) Setting of a goal and co-ordination of all parts of business to reach this goal.

(iii) To help to formulate company's policy.

(iv) To give forethought rather than hind thought to matters of importance.

(v) To help to control expenditures.

(vi) to help to determine cash requirements.

(5) Stress importance of reasonably accurate estimates. This point should be developed quite fully for if the estimates are not reasonable the whole set-up is useless.

(6) Periodic studies must be made of differences between actual and budget figures with the following possible advantages:

(i) Certain employees will obtain an intimate knowledge of business through necessary comparison studies.

(ii) Better methods may be discovered by trying to meet objectives. These might include:
Improvement in processes.
Improvement in handling.
Regrading of labour and possible change to piece work labour basis.
Quality (less rejections).
Economies in supplies.
Salvage of previous waste and rejections.
Simplification and standardization of processes.

(7) Closing with request for co-operation.